

THE COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

IN THE MATTER OF THE REVISION OF RATES

Filed by

BOSTON EDISON COMPANY
COMMONWEALTH ELECTRIC COMPANY
CAMBRIDGE ELECTRIC LIGHT COMPANY

D/B/A NSTAR ELECTRIC

D.T.E. 05-85

Appendices A through I

To accompany the

Direct Testimony

of

Paul R. Moul
Managing Consultant
P. Moul & Associates

Concerning
Cost of Equity

D.T.E. 05-85
Exhibit NSTAR Electric-PRM-1
APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

**EDUCATIONAL BACKGROUND, BUSINESS EXPERIENCE
AND QUALIFICATIONS**

I was awarded a degree of Bachelor of Science in Business Administration by Drexel University in 1971. While at Drexel, I participated in the Cooperative Education Program which included employment, for one year, with American Water Works Service Company, Inc., as an internal auditor, where I was involved in the audits of several operating water companies of the American Water Works System and participated in the preparation of annual reports to regulatory agencies and assisted in other general accounting matters.

Upon graduation from Drexel University, I was employed by American Water Works Service Company, Inc., in the Eastern Regional Treasury Department where my duties included preparation of rate case exhibits for submission to regulatory agencies, as well as responsibility for various treasury functions of the thirteen New England operating subsidiaries.

In 1973, I joined the Municipal Financial Services Department of Betz Environmental Engineers, a consulting engineering firm, where I specialized in financial studies for municipal water and wastewater systems.

In 1974, I joined Associated Utility Services, Inc., now known as AUS Consultants. I held various positions with the Utility Services Group of AUS Consultants, concluding my employment there as a Senior Vice President.

In 1994, I formed P. Moul & Associates, an independent financial and regulatory consulting firm. In my capacity as Managing Consultant and for the past twenty-nine years, I have continuously studied the rate of return requirements for cost of service regulated firms. In this regard, I have supervised the preparation of rate of return studies which were employed in

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1 connection with my testimony and in the past for other individuals. I have presented direct
2 testimony on the subject of fair rate of return, evaluated rate of return testimony of other
3 witnesses, and presented rebuttal testimony.

4 My studies and prepared direct testimony have been presented before thirty (30) federal,
5 state and municipal regulatory commissions, consisting of: the Federal Energy Regulatory
6 Commission; state public utility commissions in Alabama, Connecticut, Delaware, Florida,
7 Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts,
8 Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina,
9 Oklahoma, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, and West
10 Virginia; and the Philadelphia Gas Commission. My testimony has been offered in over 200
11 rate cases involving electric power, natural gas distribution and transmission, resource
12 recovery, solid waste collection and disposal, telephone, wastewater, and water service utility
13 companies. While my testimony has involved principally fair rate of return and financial
14 matters, I have also testified on capital allocations, capital recovery, cash working capital,
15 income taxes, factoring of accounts receivable, and take-or-pay expense recovery. My
16 testimony has been offered on behalf of municipal and investor-owned public utilities and for
17 the staff of a regulatory commission. I have also testified at an Executive Session of the State
18 of New Jersey Commission of Investigation concerning the BPU regulation of solid waste
19 collection and disposal.

20 I was a co-author of a verified statement submitted to the Interstate Commerce
21 Commission concerning the 1983 Railroad Cost of Capital (Ex Parte No. 452). I was also co-
22 author of comments submitted to the Federal Energy Regulatory Commission regarding the

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1 Generic Determination of Rate of Return on Common Equity for Public Utilities in 1985, 1986
2 and 1987 (Docket Nos. RM85-19-000, RM86-12-000, RM87-35-000 and RM88-25-000).
3 Further, I have been the consultant to the New York Chapter of the National Association of
4 Water Companies which represented the water utility group in the Proceeding on Motion of the
5 Commission to Consider Financial Regulatory Policies for New York Utilities (Case 91-M-
6 0509). I have also submitted comments to the Federal Energy Regulatory Commission in its
7 Notice of Proposed Rulemaking (Docket No. RM99-2-000) concerning Regional Transmission
8 Organizations and on behalf of the Edison Electric Institute in its intervention in the case of
9 Southern California Edison Company (Docket No. ER97-2355-000).

10 In late 1978, I arranged for the private placement of bonds on behalf of an investor-
11 owned public utility. I have assisted in the preparation of a report to the Delaware Public
12 Service Commission relative to the operations of the Lincoln and Ellendale Electric Company.
13 I was also engaged by the Delaware P.S.C. to review and report on the proposed financing and
14 disposition of certain assets of Sussex Shores Water Company (P.S.C. Docket Nos. 24-79 and
15 47-79). I was a co-author of a Report on Proposed Mandatory Solid Waste Collection
16 Ordinance prepared for the Board of County Commissioners of Collier County, Florida.

17 I have been a consultant to the Bucks County Water and Sewer Authority concerning
18 rates and charges for wholesale contract service with the City of Philadelphia. My municipal
19 consulting experience also included an assignment for Baltimore County, Maryland, regarding
20 the City/County Water Agreement for Metropolitan District customers (Circuit Court for
21 Baltimore County in Case 34/153/87-CSP-2636).

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I am a member of the Society of Utility and Regulatory Financial Analysis (formerly the National Society of Rate of Return Analysts) and have attended several Financial Forums sponsored by the Society. I attended the first National Regulatory Conference at the Marshall-Wythe School of Law, College of William and Mary. I also attended an Executive Seminar sponsored by the Colgate Darden Graduate Business School of the University of Virginia concerning Regulated Utility Cost of Equity and the Capital Asset Pricing Model. In October 1984, I attended a Standard & Poor's Seminar on the Approach to Municipal Utility Ratings, and in May 1985, I attended an S&P Seminar on Telecommunications Ratings.

My lecture and speaking engagements include:

<u>Date</u>	<u>Occasion</u>	<u>Sponsor</u>
April 2001	Thirty-third Financial Forum	Society of Utility & Regulatory Financial Analysts
December 2000	Pennsylvania Public Utility Law Conference: Non-traditional Players in the Water Industry	Pennsylvania Bar Institute
July 2000	EEI Member Workshop Developing Incentives Rates: Application and Problems	Edison Electric Institute
February 2000	The Sixth Annual FERC Briefing	Exnet and Bruder, Gentile & Marcoux, LLP
March 1994	Seventh Annual Proceeding	Electric Utility Business Environment Conf.
May 1993	Financial School	New England Gas Assoc.
April 1993	Twenty-Fifth Financial Forum	National Society of Rate of Return Analysts
June 1992	Rate and Charges Subcommittee Annual Conference	American Water Works Association
May 1992	Rates School	New England Gas Assoc.
October 1989	Seventeenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility

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1			Commissioners Florida
2			Public Service Commission
3			and University of Utah
4	October 1988	Sixteenth Annual	Water Committee of the
5		Eastern Utility	National Association
6		Rate Seminar	of Regulatory Utility
7			Commissioners, Florida
8			Public Service
9			Commission and University
10			of Utah
11	May 1988	Twentieth Financial	National Society of
12		Forum	Rate of Return Analysts
13	October 1987	Fifteenth Annual	Water Committee of the
14		Eastern Utility	National Association
15		Rate Seminar	of Regulatory Utility
16			Commissioners, Florida
17			Public Service Commis-
18			sion and University of
19			Utah
20	September 1987	Rate Committee	American Gas Association
21		Meeting	
22	May 1987	Pennsylvania	National Association of
23		Chapter	Water Companies
24		annual meeting	
25	October 1986	Eighteenth	National Society of Rate
26		Financial	of Return
27		Forum	
28	October 1984	Fifth National	American Bar Association
29		on Utility	
30		Ratemaking	
31		Fundamentals	
32	March 1984	Management Seminar	New York State Telephone
33			Association
34	February 1983	The Cost of Capital	Temple University, School
35		Seminar	of Business Admin.
36	May 1982	A Seminar on	New Mexico State
37		Regulation	University, Center for
38		and The Cost of	Business Research
39		Capital	and Services
40	October 1979	Economics of	Brown University
41		Regulation	

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RATESETTING PRINCIPLES

Under traditional cost of service regulation, an agency engaged in ratesetting, such as the Department, serves as a substitute for competition. In setting rates, a regulatory agency must carefully consider the public's interest in reasonably priced, as well as safe and reliable, service. The level of rates must also provide an opportunity to earn a rate of return for the public utility and its investors that is commensurate with the risk to which the invested capital is exposed so that the public utility has access to the capital required to meet its service responsibilities to its customers. Without an opportunity to earn a fair rate of return, a public utility will be unable to attract sufficient capital required to meet its responsibilities over time.

It is important to remember that regulated firms must compete for capital in a global market with non-regulated firms, as well as municipal, state and federal governments. Traditionally, a public utility has been responsible for providing a particular type of service to its customers within a specific market area. Although this relationship with its customers has been changing, it remains quite different from a non-regulated firm which is free to enter and exit competitive markets in accordance with available business opportunities.

As established by the landmark Bluefield and Hope cases,¹ several tests must be satisfied to demonstrate the fairness or reasonableness of the rate of return. These tests include a determination of whether the rate of return is (i) similar to that of other financially sound businesses having similar or comparable risks, (ii) sufficient to ensure confidence in the financial integrity of the public utility, and (iii) adequate to maintain and support the credit of

¹ Bluefield Water Works & Improvement Co. v. P.S.C. of West Virginia, 262 U.S. 679 (1923) and F.P.C. v. Hope Natural Gas Co., 320 U.S. 591 (1944).

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1 the utility, thereby enabling it to attract, on a reasonable cost basis, the funds necessary to
2 satisfy its capital requirements so that it can meet the obligation to provide adequate and
3 reliable service to the public.

4 A fair rate of return must not only provide the utility with the ability to attract new
5 capital, it must also be fair to existing investors. An appropriate rate of return which may have
6 been reasonable at one point in time may become too high or too low at a subsequent point in
7 time, based upon changing business risks, economic conditions and alternative investment
8 opportunities. When applying the standards of a fair rate of return, it must be recognized that
9 the end result must provide for the payment of interest on the company's debt, the payment of
10 dividends on the company's stock, the recovery of costs associated with securing capital, the
11 maintenance of reasonable credit quality for the company, and support of the company's
12 financial condition, which today would include those measures of financial performance in the
13 areas of interest coverage and adequate cash flow derived from a reasonable level of earnings.

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EVALUATION OF RISK

1 The rate of return required by investors is directly linked to the perceived level of risk.
2
3 The greater the risk of an investment, the higher is the required rate of return necessary to
4 compensate for that risk all else being equal. Because investors will seek the highest rate of
5 return available, considering the risk involved, the rate of return must at least equal the
6 investor-required, market-determined cost of capital if public utilities are to attract the
7 necessary investment capital on reasonable terms.

8 In the measurement of the cost of capital, it is necessary to assess the risk of a firm.
9 The level of risk for a firm is often defined as the uncertainty of achieving expected
10 performance, and is sometimes viewed as a probability distribution of possible outcomes.
11 Hence, if the uncertainty of achieving an expected outcome is high, the risk is also high. As a
12 consequence, high risk firms must offer investors higher returns than low risk firms which pay
13 less to attract capital from investors. This is because the level of uncertainty, or risk of not
14 realizing expected returns, establishes the compensation required by investors in the capital
15 markets. Of course, the risk of a firm must also be considered in the context of its ability to
16 actually experience adequate earnings which conform with a fair rate of return. Thus, if there is
17 a high probability that a firm will not perform well due to fundamentally poor market
18 conditions, investors will demand a higher return.

19 The investment risk of a firm is comprised of its business risk and financial risk.
20 Business risk is all risk other than financial risk, and is sometimes defined as the staying power
21 of the market demand for a firm's product or service and the resulting inherent uncertainty of
22 realizing expected pre-tax returns on the firm's assets. Business risk encompasses all operating

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1 factors, e.g., productivity, competition, management ability, etc. that bear upon the expected
2 pre-tax operating income attributed to the fundamental nature of a firm's business. Financial
3 risk results from a firm's use of borrowed funds (or similar sources of capital with fixed
4 payments) in its capital structure, i.e., financial leverage. Thus, if a firm did not employ
5 financial leverage by borrowing any capital, its investment risk would be represented by its
6 business risk.

7 It is important to note that in evaluating the risk of regulated companies, financial
8 leverage cannot be considered in the same context as it is for non-regulated companies.
9 Financial leverage has a different meaning for regulated firms than for non-regulated
10 companies. For regulated public utilities, the cost of service formula gives the benefits of
11 financial leverage to consumers in the form of lower revenue requirements. For non-regulated
12 companies, all benefits of financial leverage are retained by the common stockholder.
13 Although retaining none of the benefits, regulated firms bear the risk of financial leverage.
14 Therefore, a regulated firm's rate of return on common equity must recognize the greater
15 financial risk shown by the higher leverage typically employed by public utilities.

16 Although no single index or group of indices can precisely quantify the relative
17 investment risk of a firm, financial analysts use a variety of indicators to assess that risk. For
18 example, the creditworthiness of a firm is revealed by its bond ratings. If the stock is traded,
19 the price-earnings multiple, dividend yield, and beta coefficients (a statistical measure of a
20 stock's relative volatility to the rest of the market) provide some gauge of overall risk. Other
21 indicators, which are reflective of business risk, include the variability of the rate of return on
22 equity, which is indicative of the uncertainty of actually achieving the expected earnings;

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1 operating ratios (the percentage of revenues consumed by operating expenses, depreciation, and
2 taxes other than income tax), which are indicative of profitability; the quality of earnings,
3 which considers the degree to which earnings are the product of accounting principles or cost
4 deferrals; and the level of internally generated funds. Similarly, the proportion of senior capital
5 in a company's capitalization is the measure of financial risk which is often analyzed in the
6 context of the equity ratio (i.e., the complement of the debt ratio).

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COST OF EQUITY--GENERAL APPROACH

Through a fundamental financial analysis, the relative risk of a firm must be established prior to the determination of its cost of equity. Any rate of return recommendation which lacks such a basis will inevitably fail to provide a utility with a fair rate of return except by coincidence. With a fundamental risk analysis as a foundation, standard financial models can be employed by using informed judgment. The methods which have been employed to measure the cost of equity include: the Discounted Cash Flow ("DCF") model, the Risk Premium ("RP") approach, the Capital Asset Pricing Model ("CAPM") and the Comparable Earnings ("CE") approach.

The traditional DCF model, while useful in providing some insight into the cost of equity, is not an approach that should be used exclusively. The divergence of stock prices from company-specific fundamentals can provide a misleading cost of equity calculation. As reported in The Wall Street Journal on June 6, 1991, a statistical study published by Goldman Sachs indicated that only 35% of stock price growth in the 1980's could be attributed to earnings and interest rates. Further, 38% of the rise in stock prices during the 1980's was attributed to unknown factors. The Goldman Sachs study highlights the serious limitations of a model, such as DCF, which is founded upon identification of specific variables to explain stock price growth. That is to say, when stock price growth exceeds growth in a company's earnings per share, models such as DCF will misspecify investor expected returns which are comprised of capital gains, as well as dividend receipts. As such, a combination of methods should be used to measure the cost of equity.

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1 The Risk Premium analysis is founded upon the prospective cost of long-term debt, i.e.,
2 the yield that the public utility must offer to raise long-term debt capital directly from investors.
3 To that yield must be added a risk premium in recognition of the greater risk of common equity
4 over debt. This additional risk is, of course, attributable to the fact that the payment of interest
5 and principal to creditors has priority over the payment of dividends and return of capital to
6 equity investors. Hence, equity investors require a higher rate of return than the yield on long-
7 term corporate bonds.

8 The CAPM is a model not unlike the traditional Risk Premium. The CAPM employs
9 the yield on a risk-free interest-bearing obligation plus a premium as compensation for risk.
10 Aside from the reliance on the risk-free rate of return, the CAPM gives specific quantification
11 to systematic (or market) risk as measured by beta.

12 The Comparable Earnings approach measures the returns expected/experienced by other
13 non-regulated firms and has been used extensively in rate of return analysis for over a half
14 century. However, its popularity diminished in the 1970s and 1980s with the popularization of
15 market-based models. Recently, there has been renewed interest in this approach. Indeed, the
16 financial community has expressed the view that the regulatory process must consider the
17 returns which are being achieved in the non-regulated sector so that public utilities can compete
18 effectively in the capital markets. Indeed, with additional competition being introduced
19 throughout the traditionally regulated public utility industry, returns expected to be realized by
20 non-regulated firms have become increasingly relevant in the ratesetting process. The
21 Comparable Earnings approach considers directly those requirements and it fits the established

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1 standards for a fair rate of return set forth in the Bluefield and Hope decisions. The Hope
2 decision requires that a fair return for a utility must be equal to that earned by firms of
3 comparable risk.

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DISCOUNTED CASH FLOW ANALYSIS

Discounted Cash Flow ("DCF") theory seeks to explain the value of an economic or financial asset as the present value of future expected cash flows discounted at the appropriate risk-adjusted rate of return. Thus, if \$100 is to be received in a single payment 10 years subsequent to the acquisition of an asset, and the appropriate risk-related interest rate is 8%, the present value of the asset would be \$46.32 ($\text{Value} = \$100 / (1.08)^{10}$) arising from the discounted future cash flow. Conversely, knowing the present \$46.32 price of an asset (where price = value), the \$100 future expected cash flow to be received 10 years hence shows an 8% annual rate of return implicit in the price and future cash flows expected to be received.

In its simplest form, the DCF theory considers the number of years from which the cash flow will be derived and the annual compound interest rate which reflects the risk or uncertainty associated with the cash flows. It is appropriate to reiterate that the dollar values to be discounted are future cash flows.

DCF theory is flexible and can be used to estimate value (or price) or the annual required rate of return under a wide variety of conditions. The theory underlying the DCF methodology can be easily illustrated by utilizing the investment horizon associated with a preferred stock not having an annual sinking fund provision. In this case, the investment horizon is infinite, which reflects the perpetuity of a preferred stock. If P represents price, K_p is the required rate of return on a preferred stock, and D is the annual dividend (P and D with time subscripts), the value of a preferred share is equal to the present value of the dividends to be received in the future discounted at the appropriate risk-adjusted interest rate, K_p . In this circumstance:

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$$P_0 = \frac{D_1}{(1 + Kp)} + \frac{D_2}{(1 + Kp)^2} + \frac{D_3}{(1 + Kp)^3} + \dots + \frac{D_n}{(1 + Kp)^n}$$

1 If $D_1 = D_2 = D_3 = \dots D_n$ as is the case for preferred stock, and n approaches infinity, as is the
2 case for non-callable preferred stock without a sinking fund, then this equation reduces to:

3

4
$$P_0 = \frac{D_1}{Kp}$$

5 This equation can be used to solve for the annual rate of return on a preferred stock when the
6 current price and subsequent annual dividends are known. For example, with $D_1 = \$1.00$, and
7 $P_0 = \$10$, then $Kp = \$1.00 \div \10 , or 10%.

8 The dividend discount equation, first shown, is the generic DCF valuation model for all
9 equities, both preferred and common. While preferred stock generally pays a constant dividend,
10 permitting the simplification subsequently noted, common stock dividends are not constant.
11 Therefore, absent some other simplifying condition, it is necessary to rely upon the generic
12 form of the DCF. If, however, it is assumed that $D_1, D_2, D_3, \dots D_n$ are systematically related to
13 one another by a constant growth rate (g), so that $D_0 (1 + g) = D_1, D_1 (1 + g) = D_2, D_2 (1 + g)$
14 $= D_3$ and so on approaching infinity, and if Ks (the required rate of return on a common stock)
15 is greater than g , then the DCF equation can be reduced to:

$$P_0 = \frac{D_1}{Ks - g} \text{ or } P_0 = \frac{D_0 (1 + g)}{Ks - g}$$

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1 which is the periodic form of the "Gordon" model.¹ Proof of the DCF equation is found in all
2 modern basic finance textbooks. This DCF equation can be easily solved as:

$$K_S = \frac{D_0(1+g)}{P_0} + g$$

3
4 which is the periodic form of the Gordon Model commonly applied in estimating equity rates
5 of return in rate cases. When used for this purpose, K_S is the annual rate of return on common
6 equity demanded by investors to induce them to hold a firm's common stock. Therefore, the
7 variables D_0 , P_0 and g must be estimated in the context of the market for equities, so that the
8 rate of return, which a public utility is permitted the opportunity to earn, has meaning and
9 reflects the investor-required cost rate.

10 Application of the Gordon model with market derived variables is straightforward. For
11 example, using the most recent prior annualized dividend (D_0) of \$0.80, the current price (P_0)
12 of \$10.00, and the investor expected dividend growth rate (g) of 5%, the solution of the DCF
13 formula provides a 13.4% rate of return. The dividend yield component in this instance is
14 8.4%, and the capital gain component is 5%, which together represent the total 13.4% annual
15 rate of return required by investors. The capital gain component of the total return may be
16 calculated with two adjacent future year prices. For example, in the eleventh year of the
17 holding period, the price per share would be \$17.10 as compared with the price per share of
18 \$16.29 in the tenth year which demonstrates the 5% annual capital gain yield.

¹ Although the popular application of the DCF model is often attributed to the work of Myron J. Gordon in the mid-1950's, J. B. Williams explicated the DCF model in its present form nearly two decades earlier.

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1 Some DCF devotees believe that it is more appropriate to estimate the required return
2 on equity with a model which permits the use of multiple growth rates. This may be a plausible
3 approach to DCF, where investors expect different dividend growth rates in the near term and
4 long run. If two growth rates, one near term and one long-run, are to be used in the context of a
5 price (P_0) of \$10.00, a dividend (D_0) of \$0.80, a near-term growth rate of 5.5%, and a long-run
6 expected growth rate of 5.0% beginning at year 6, the required rate of return is 13.57% solved
7 with a computer by iteration.

Use of DCF in Ratesetting

9 The DCF method can provide a misleading measure of the cost of equity in the
10 ratesetting process when stock prices diverge from book values by a meaningful margin. When
11 the difference between share values and book values is significant, the results from the DCF
12 can result in a misspecified cost of equity when those results are applied to book value. This is
13 because investor expected returns, as described by the DCF model, are related to the market
14 value of common stock. This discrepancy is shown by the following example. If it is assumed,
15 hypothetically, that investors require a 12.5% return on their common stock investment value
16 (i.e., the market price per share) when share values represent 150% of book value, investors
17 would require a total annual return of \$1.50 per share on a \$12.00 market value to realize their
18 expectations. If, however, this 12.5% market-determined cost rate is applied to an original cost
19 rate base which is equivalent to the book value of common stock of \$8.00 per share, the utility's
20 actual earnings per share would be only \$1.00. This would result in a \$.50 per share earnings
21 shortfall which would deny the utility the ability to satisfy investor expectations.

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1 As a consequence, a utility could not withstand these DCF results applied in a rate case
2 and also sustain its financial integrity. This is because \$1.00 of earnings per share and a 75%
3 dividend payout ratio would provide earnings retention growth of just 3.125% (i.e., $\$1.00 \times .75$
4 = $\$0.75$, and $\$1.00 - \$0.75 = \$0.25 \div \$8.00 = 3.125\%$). In this example, the earnings retention
5 growth rate plus the 6.25% dividend yield ($\$0.75 \div \12.00) would equal 9.375% (6.25% +
6 3.125%) as indicated by the DCF model. This DCF result is the same as the utility's rate of
7 dividend payments on its book value (i.e., $\$0.75 \div \$8.00 = 9.375\%$). This situation provides
8 the utility with no earnings cushion for its dividend payment because the DCF result equals the
9 dividend rate on book value (i.e., both rates are 9.375% in the example). Moreover, if the price
10 employed in my example were higher than 150% of book value, a "negative" earnings cushion
11 would develop and cause the need for a dividend reduction because the DCF result would be
12 less than the dividend rate on book value. For these reasons, the usefulness of the DCF method
13 significantly diminishes as market prices and book values diverge.

14 Further, there is no reason to expect that investors would necessarily value utility stocks
15 equal to their book value. In fact, it is rare that utility stocks trade at book value. Moreover,
16 high market-to-book ratios may be reflective of general market sentiment. Were regulators to
17 use the results of a DCF model, that fails to produce the required return when applied to an
18 original cost rate base, they would penalize a company with high market-to-book ratios. This
19 clearly would penalize a regulated firm and its investors that purchased the stock at its current
20 price. When investor expectations are not fulfilled, the market price per share will decline and
21 a new, different equity cost rate would be indicated from the lower price per share. This
22 condition suggests that the current price would be subject to disequilibrium and would not

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1 allow a reasonable calculation of the cost of equity. This situation would also create a serious
2 disincentive for management initiative and efficiency. Within that framework, a perverse set of
3 goals and rewards would result, i.e., a high authorized rate of return in a rate case would be the
4 reward for poor financial performance, while low rates of return would be the reward for good
5 financial performance. As such, the DCF results should not be used alone to determine the cost
6 of equity, but should be used along with other complementary methods.

Dividend Yield

8 The historical annual dividend yield for the Electric Group is shown on Schedule 3.
9 The 2000-2004 five-year average dividend yield was 5.0% for the Electric Group. The
10 monthly dividend yields for the past twelve months are shown graphically on Schedule 5.
11 These dividend yields reflect an adjustment to the month-end closing prices to remove the pro
12 rata accumulation of the quarterly dividend amount since the last ex-dividend date.

13 The ex-dividend date usually occurs two business days before the record date of the
14 dividend (i.e., the date by which a shareholder must own the shares to be entitled to the
15 dividend payment--usually about two to three weeks prior to the actual payment). During a
16 quarter (here defined as 91 days), the price of a stock moves up ratably by the dividend amount
17 as the ex-dividend date approaches. The stock's price then falls by the amount of the dividend
18 on the ex-dividend date. Therefore, it is necessary to calculate the fraction of the quarterly
19 dividend since the time of the last ex-dividend date and to remove that amount from the price.
20 This adjustment reflects normal recurring pricing of stocks in the market, and establishes a
21 price which will reflect the true yield on a stock.

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A six-month average dividend yield has been used to recognize the prospective orientation of the ratesetting process as explained in the direct testimony. For the purpose of a DCF calculation, the average dividend yields must be adjusted to reflect the prospective nature of the dividend payments, i.e., the higher expected dividends for the future rather than the recent dividend payment annualized. An adjustment to the dividend yield component, when computed with annualized dividends, is required based upon investor expectation of quarterly dividend increases.

The procedure to adjust the average dividend yield for the expectation of a dividend increase during the initial investment period will be at a rate of one-half the growth component, developed below. The DCF equation, showing the quarterly dividend payments as D_0 , may be stated in this fashion:

$$K = \frac{D_0 (1+g)^0 + D_0 (1+g)^0 + D_0 (1+g)^1 + D_0 (1+g)^1}{P_0} + g$$

The adjustment factor, based upon one-half the expected growth rate developed in my direct testimony, will be 2.500% (5.00% x .5) for the Electric Group, which assumes that two dividend payments will be at the expected higher rate during the initial investment period. Using the six-month average dividend yield as a base, the prospective (forward) dividend yield would be 4.61% (4.50% x 1.02500) for the Electric Group.

Another DCF model that reflects the discrete growth in the quarterly dividend (D_0) is as follows:

$$K = \frac{D_0 (1+g)^{.25} + D_0 (1+g)^{.50} + D_0 (1+g)^{.75} + D_0 (1+g)^{1.00}}{F.7 P_0} + g$$

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1 This procedure confirms the reasonableness of the forward dividend yield previously
2 calculated. The quarterly discrete adjustment provides a dividend yield of 4.64% (4.50% x
3 1.03106) for the Electric Group. The use of an adjustment is required for the periodic form of
4 the DCF in order to properly recognize that dividends grow on a discrete basis.

5 In either of the preceding DCF dividend yield adjustments, there is no recognition for
6 the compound returns attributed to the quarterly dividend payments. Investors have the
7 opportunity to reinvest quarterly dividend receipts. Recognizing the compounding of the
8 periodic quarterly dividend payments (D_0), results in a third DCF formulation:

$$k = \left[\left(1 + \frac{D_0}{P_0} \right)^4 - 1 \right] + g$$

9 This DCF equation provides no further recognition of growth in the quarterly dividend.
10 Combining discrete quarterly dividend growth with quarterly compounding would provide the
11 following DCF formulation, stating the quarterly dividend payments (D_0):

$$k = \left[\left(1 + \frac{D_0 (1 + g)^{25}}{P_0} \right)^4 - 1 \right] + g$$

12 A compounding of the quarterly dividend yield provides another procedure to recognize the
13 necessity for an adjusted dividend yield. The unadjusted average quarterly dividend yield was
14 1.1250% (4.50% ÷ 4) for the Electric Group. The compound dividend yield would be 4.63%

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1 (1.011388⁴-1) for the Electric Group, recognizing quarterly dividend payments in a forward-
2 looking manner. These dividend yields conform with investors' expectations in the context of
3 reinvestment of their cash dividend.

4 For the Electric Group, a 4.63% forward-looking dividend yield is the average (4.61%
5 + 4.64% + 4.63% = 13.88% ÷ 3) of the adjusted dividend yield using the form $D_0/P_0 (1+.5g)$,
6 the dividend yield recognizing discrete quarterly growth, and the quarterly compound dividend
7 yield with discrete quarterly growth.

Growth Rate

8
9 If viewed in its infinite form, the DCF model is represented by the discounted value of
10 an endless stream of growing dividends. It would, however, require 100 years of future
11 dividend payments so that the discounted value of those payments would equate to the present
12 price so that the discount rate and the rate of return shown by the simplified Gordon form of the
13 DCF model would be about the same. A century of dividend receipts represents an unrealistic
14 investment horizon from almost any perspective. Because stocks are not held by investors
15 forever, the growth in the share value (i.e., capital appreciation, or capital gains yield) is most
16 relevant to investors' total return expectations. Hence, investor expected returns in the equity
17 market are provided by capital appreciation of the investment as well as receipt of dividends.
18 As such, the sale price of a stock can be viewed as a liquidating dividend which can be
19 discounted along with the annual dividend receipts during the investment holding period to
20 arrive at the investor expected return.

21 In its constant growth form, the DCF assumes that with a constant return on book
22 common equity and constant dividend payout ratio, a firm's earnings per share, dividends per

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1 share and book value per share will grow at the same constant rate, absent any external
2 financing by a firm. Because these constant growth assumptions do not actually prevail in the
3 capital markets, the capital appreciation potential of an equity investment is best measured by
4 the expected growth in earnings per share. Since the traditional form of the DCF assumes no
5 change in the price-earnings multiple, the value of a firm's equity will grow at the same rate as
6 earnings per share. Hence, the capital gains yield is best measured by earnings per share
7 growth using company-specific variables.

8 Investors consider both historical and projected data in the context of the expected
9 growth rate for a firm. An investor can compute historical growth rates using compound
10 growth rates or growth rate trend lines. Otherwise, an investor can rely upon published growth
11 rates as provided in widely-circulated, influential publications. However, a traditional constant
12 growth DCF analysis that is limited to such inputs suffers from the assumption of no change in
13 the price-earnings multiple, i.e., that the value of a firm's equity will grow at the same rate as
14 earnings. Some of the factors which actually contribute to investors' expectations of earnings
15 growth and which should be considered in assessing those expectations, are: (i) the earnings
16 rate on existing equity, (ii) the portion of earnings not paid out in dividends, (iii) sales of
17 additional common equity, (iv) reacquisition of common stock previously issued, (v) changes
18 in financial leverage, (vi) acquisitions of new business opportunities, (vii) profitable liquidation
19 of assets, and (viii) repositioning of existing assets. The realities of the equity market regarding
20 total return expectations, however, also reflect factors other than these inputs. Therefore, the
21 DCF model contains overly restrictive limitations when the growth component is stated in
22 terms of earnings per share (the basis for the capital gains yield) or dividends per share (the

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1 basis for the infinite dividend discount model). In these situations, there is inadequate
2 recognition of the capital gains yields arising from stock price growth which could exceed
3 earnings or dividends growth.

4 To assess the growth component of the DCF, analysts' projections of future growth
5 influence investor expectations as explained above. One influential publication is The Value
6 Line Investment Survey which contains estimated future projections of growth. The Value
7 Line Investment Survey provides growth estimates which are stated within a common
8 economic environment for the purpose of measuring relative growth potential. The basis for
9 these projections is the Value Line 3 to 5 year hypothetical economy. The Value Line
10 hypothetical economic environment is represented by components and subcomponents of the
11 National Income Accounts which reflect in the aggregate assumptions concerning the
12 unemployment rate, manpower productivity, price inflation, corporate income tax rate, high-
13 grade corporate bond interest rates, and Fed policies. Individual estimates begin with the
14 correlation of sales, earnings and dividends of a company to appropriate components or
15 subcomponents of the future National Income Accounts. These calculations provide a
16 consistent basis for the published forecasts. Value Line's evaluation of a specific company's
17 future prospects are considered in the context of specific operating characteristics that influence
18 the published projections. Of particular importance for regulated firms, Value Line considers
19 the regulatory quality, rates of return recently authorized, the historic ability of the firm to
20 actually experience the authorized rates of return, the firm's budgeted capital spending, the
21 firm's financing forecast, and the dividend payout ratio. The wide circulation of this source and

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1 frequent reference to Value Line in financial circles indicate that this publication has an
2 influence on investor judgment with regard to expectations for the future.

3 There are other sources of earnings growth forecasts. One of these sources is the
4 Institutional Brokers Estimate System ("IBES"). The IBES service provides data on consensus
5 earnings per share forecasts and five-year earnings growth rate estimates. The publisher of
6 IBES has been purchased by Thomson/First Call. The IBES forecasts have been integrated into
7 the First Call consensus growth forecasts. The earnings estimates are obtained from financial
8 analysts at brokerage research departments and from institutions whose securities analysts are
9 projecting earnings for companies in the First Call universe of companies. Other services that
10 tabulate earnings forecasts and publish them are Zacks Investment Research and Market Guide
11 (which is provided over the Internet by Reuters). As with the IBES/First Call forecasts, Zacks
12 and Reuters/Market Guide provide consensus forecasts collected from analysts for most
13 publically traded companies.

14 In each of these publications, forecasts of earnings per share for the current and
15 subsequent year receive prominent coverage. That is to say, IBES/First Call, Zacks,
16 Reuters/Market Guide, and Value Line show estimates of current-year earnings and projections
17 for the next year. While the DCF model typically focusses upon long-run estimates of growth,
18 stock prices are clearly influenced by current and near-term earnings prospects. Therefore, the
19 near-term earnings per share growth rates should also be factored into a growth rate
20 determination.

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1 Although forecasts of future performance are investor influencing², equity investors
2 may also rely upon the observations of past performance. Investors' expectations of future
3 growth rates may be determined, in part, by an analysis of historical growth rates. It is apparent
4 that any serious investor would advise himself/herself of historical performance prior to taking
5 an investment position in a firm. Earnings per share and dividends per share represent the
6 principal financial variables which influence investor growth expectations.

7 Other financial variables are sometimes considered in rate case proceedings. For
8 example, a company's internal growth rate, derived from the return rate on book common
9 equity and the related retention ratio, is sometimes considered. This growth rate measure is
10 represented by the Value Line forecast "BxR" shown on Schedule 7 Internal growth rates are
11 often used as a proxy for book value growth. Unfortunately, this measure of growth is often
12 not reflective of investor-expected growth. This is especially important when there is an
13 indication of a prospective change in dividend payout ratio, earned return on book common
14 equity, change in market-to-book ratios or other fundamental changes in the character of the
15 business. Nevertheless, I have also shown the historical and projected growth rates in book
16 value per share and internal growth rates.

Leverage Adjustment

17
18 As noted previously, the divergence of stock prices from book values creates a conflict
19 within the DCF model when the results of a market-derived cost of equity are applied to the
20 common equity account measured at book value in the ratesetting context. This is the situation
21 today where the market price of stock exceeds its book value for most companies. This

² As shown in a National Bureau of Economic Research monograph by John G. Cragg and Burton G. Malkiel, Expectations and the Structure of Share Prices, University of Chicago Press 1982.

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divergence of price and book value also creates a financial risk difference, whereby the capitalization of a utility measured at its market value contains relatively less debt and more equity than the capitalization measured at its book value. It is a well-accepted fact of financial theory that a relatively higher proportion of equity in the capitalization has less financial risk than another capital structure more heavily weighted with debt. This is the situation for the Electric Group where the market value of its capitalization contains more equity than is shown by the book capitalization. The following comparison demonstrates this situation where the market capitalization is developed by taking the "Fair Value of Financial Instruments" (Disclosures about Fair Value of Financial Instruments -- Statement of Financial Accounting Standards ("FAS") No. 107) as shown in the annual report for these companies and the market value of the common equity using the price of stock. The comparison of capital structure ratios is:

<u>Electric Group</u>	<u>Capitalization at Market Value (Fair Value)</u>	<u>Capitalization at Book Value (Carrying Amounts)</u>
Long-term Debt	43.11%	49.23%
Preferred Stock	1.74	2.34
Common Equity	<u>55.15</u>	<u>48.44</u>
Total	<u>100.00%</u>	<u>100.00%</u>

With regard to the capital structure ratios represented by the carrying amounts shown above, there are some variances from the ratios shown on Schedule 3. These variances arise from the use of balance sheet values in computing the capital structure ratios shown on Schedule 3 and the use of the Carrying Amounts of the Financial Instruments according to FAS 107 (the Carrying Amounts were used in the table shown above to be comparable to the Fair Value amounts used in the comparison calculations).

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With the capital ratios calculated above, is necessary to first calculate the cost of equity for a firm without any leverage. The cost of equity for an unleveraged firm using the capital structure ratios calculated with market values is:

$$k_u = k_e - (((k_u - i) (1-t) D / E) - (k_u - d) P / E)$$

$$8.24\% = 9.63\% - (((8.24\% - 5.63\%) .65) 43.11\% / 55.15\%) - (8.24\% - 6.24\%) 1.74\% / 55.15\%$$

where k_u = cost of equity for an all-equity firm, k_e = market determined cost equity, i = cost of debt³, d = dividend rate on preferred stock⁴, D = debt ratio, P = preferred stock ratio, and E = common equity ratio. The formula shown above indicates that the cost of equity for a firm with 100% equity is 8.24% using the market value of the Electric Group's capitalization. Having determined that the cost of equity is 8.24% for a firm with 100% equity, the rate of return on common equity associated with the book value capital structure is:

$$k_e = k_u + (((k_u - i) (1-t) D / E) + (k_u - d) P / E)$$

$$10.07\% = 8.24\% + (((8.24\% - 5.63\%) .65) 49.23\% / 48.44\%) + (8.24\% - 6.24\%) 2.34\% / 48.44\%$$

³ The cost of debt is the six-month average yield on Moody's A rated public utility bonds.

⁴ The cost of preferred is the six-month average yield on Moody's "a" rated preferred stock.

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INTEREST RATES

Interest rates can be viewed in their traditional nominal terms (i.e., the stated rate of interest) and in real terms (i.e., the stated rate of interest less the expected rate of inflation). Absent consideration of inflation, the real rate of interest is determined generally by supply factors which are influenced by investors willingness to forego current consumption (i.e., to save) and demand factors that are influenced by the opportunities to derive income from productive investments. Added to the real rate of interest is compensation required by investors for the inflationary impact of the declining purchasing power of their income received in the future. While interest rates are clearly influenced by the changing annual rate of inflation, it is important to note that the expected rate of inflation, that is reflected in current interest rates, may be quite different than the prevailing rate of inflation.

Rates of interest also vary by the type of interest bearing instrument. Investors require compensation for the risk associated with the term of the investment and the risk of default. The risk associated with the term of the investment is usually shown by the yield curve, i.e., the difference in rates across maturities. The typical structure is represented by a positive yield curve which provides progressively higher interest rates as the maturities are lengthened. Flat (i.e., relatively level rates across maturities) or inverted (i.e., higher short-term rates than long-term rates) yield curves occur less frequently.

The risk of default is typically associated with the creditworthiness of the borrower. Differences in interest rates can be traced to the credit quality ratings assigned by the bond rating agencies, such as Moody's Investors Service, Inc. and Standard & Poor's Corporation. Obligations of the United States Treasury are usually considered to be free of default risk, and

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1 hence reflect only the real rate of interest, compensation for expected inflation, and maturity
2 risk. The Treasury has been issuing inflation-indexed notes which automatically provide
3 compensation to investors for future inflation, thereby providing a lower current yield on these
4 issues.

Interest Rate Environment

6 Federal Reserve Board ("Fed") policy actions which impact directly short-term interest
7 rates also substantially affect investor sentiment in long-term fixed-income securities markets.
8 In this regard, the Fed has often pursued policies designed to build investor confidence in the
9 fixed-income securities market. Formative Fed policy has had a long history, as exemplified by
10 the historic 1951 Treasury-Federal Reserve Accord, and more recently, deregulation within the
11 financial system which increased the level and volatility of interest rates. The Fed has
12 indicated that it will follow a monetary policy designed to promote noninflationary economic
13 growth.

14 As background to the recent levels of interest rates, history shows that the Open Market
15 Committee of the Federal Reserve board ("FOMC") began a series of moves toward lower
16 short-term interest rates in mid-1990 -- at the outset of the previous recession. Monetary policy
17 was influenced at that time by (i) steps taken to reduce the federal budget deficit, (ii) slowing
18 economic growth, (iii) rising unemployment, and (iv) measures intended to avoid a credit
19 crunch. Thereafter, the Federal government initiated several bold proposals to deal with future
20 borrowings by the Treasury. With lower expected federal budget deficits and reduced Treasury
21 borrowings, together with limitations on the supply of new 30-year Treasury bonds, long-term
22 interest rates declined to a twenty-year low, reaching a trough of 5.78% in October 1993.

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1 On February 4, 1994, the FOMC began a series of increases in the Fed Funds rate (i.e.,
2 the interest rate on excess overnight bank reserves). The initial increase represented the first
3 rise in short-term interest rates in five years. The series of seven increases doubled the Fed
4 Funds rate to 6%. The increases in short-term interest rates also caused long-term rates to
5 move up, continuing a trend which began in the fourth quarter of 1993. The cyclical peak in
6 long-term interest rates was reached on November 7 and 14, 1994 when 30-year Treasury
7 bonds attained an 8.16% yield. Thereafter, long-term Treasury bond yields generally declined.

8 Beginning in mid-February 1996, long-term interest rates moved upward from their
9 previous lows. After initially reaching a level of 6.75% on March 15, 1996, long-term interest
10 rates continued to climb and reached a peak of 7.19% on July 5 and 8, 1996. For the period
11 leading up to the 1996 Presidential election, long-term Treasury bonds generally traded within
12 this range. After the election, interest rates moderated, returning to a level somewhat below the
13 previous trading range. Thereafter, in December 1996, interest rates returned to a range of
14 6.5% to 7.0% which existed for much of 1996.

15 On March 25, 1997, the FOMC decided to tighten monetary conditions through a one-
16 quarter percentage point increase in the Fed Funds rate. This tightening increased the Fed
17 Funds rate to 5.5%. In making this move, the FOMC stated that it was concerned by persistent
18 strength of demand in the economy, which it feared would increase the risk of inflationary
19 imbalances that could eventually interfere with the long economic expansion.

20 In the fourth quarter of 1997, the yields on Treasury bonds began to decline rapidly in
21 response to an increase in demand for Treasury securities caused by a flight to safety triggered
22 by the currency and stock market crisis in Asia. Liquidity provided by the Treasury market

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1 makes these bonds an attractive investment in times of crisis. This is because Treasury
2 securities encompass a very large market which provides ease of trading and carry a premium
3 for safety. During the fourth quarter of 1997, Treasury bond yields pierced the psychologically
4 important 6% level for the first time since 1993.

5 Through the first half of 1998, the yields on long-term Treasury bonds fluctuated within
6 a range of about 5.6% to 6.1% reflecting their attractiveness and safety. In the third quarter of
7 1998, there was further deterioration of investor confidence in global financial markets. This
8 loss of confidence followed the moratorium (i.e., default) by Russia on its sovereign debt and
9 fears associated with problems in Latin America. While not significant to the global economy
10 in the aggregate, the August 17 default by Russia had a significant negative impact on investor
11 confidence, following earlier discontent surrounding the crisis in Asia. These events
12 subsequently led to a general pull back of risk-taking as displayed by banks growing reluctance
13 to lend, worries of an expanding credit crunch, lower stock prices, and higher yields on bonds
14 of riskier companies. These events contributed to the failure of the hedge fund, Long-Term
15 Capital Management.

16 In response to these events, the FOMC cut the Fed Funds rate just prior to the mid-term
17 Congressional elections. The FOMC's action was based upon concerns over how increasing
18 weakness in foreign economies would affect the U.S. economy. As recently as July 1998, the
19 FOMC had been more concerned about fighting inflation than the state of the economy. The
20 initial rate cut was the first of three reductions by the FOMC. Thereafter, the yield on long-
21 term Treasury bonds reached a 30-year low of 4.70% on October 5, 1998. Long-term Treasury
22 yields below 5% had not been seen since 1967. Unlike the first rate cut that was widely

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1 anticipated, the second rate reduction by the FOMC was a surprise to the markets. A third
2 reduction in short-term interest rates occurred in November 1998 when the FOMC reduced the
3 Fed Funds rate to 4.75%.

4 All of these events prompted an increase in the prices for Treasury bonds which lead to
5 the low yields described above. Another factor that contributed to the decline in yields on
6 long-term Treasury bonds was a reduction in the supply of new Treasury issues coming to
7 market due to the Federal budget surplus -- the first in nearly 30 years. The dollar amount of
8 Treasury bonds being issued declined by 30% in two years thus resulting in higher prices and
9 lower yields. In addition, rumors of some struggling hedge funds unwinding their positions
10 further added to the gains in Treasury bond prices.

11 The financial crisis that spread from Asia to Russia and to Latin America pushed
12 nervous investors from stocks into Treasury bonds, thus increasing demand for bonds, just
13 when supply was shrinking. There was also a move from corporate bonds to Treasury bonds to
14 take advantage of appreciation in the Treasury market. This resulted in a certain amount of
15 exuberance for Treasury bond investments that formerly was reserved for the stock market.
16 Moreover, yields in the fourth quarter of 1998 became extremely volatile as shown by Treasury
17 yields that fell from 5.10% on September 29 to 4.70 percent on October 5, and thereafter
18 returned to 5.10% on October 13. A decline and rebound of 40 basis points in Treasury yields
19 in a two-week time frame is remarkable.

20 Beginning in mid-1999, the FOMC raised interest rates on six occasions reversing its
21 actions in the fall of 1998. On June 30, 1999, August 24, 1999, November 16, 1999, February
22 2, 2000, March 21, 2000, and May 16, 2000, the FOMC raised the Fed Funds rate to 6.50%.

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1 This brought the Fed Funds rate to its highest level since 1991, and was 175 basis points higher
2 than the level that occurred at the height of the Asian currency and stock market crisis. At the
3 time, these actions were taken in response to more normally functioning financial markets, tight
4 labor markets, and a reversal of the monetary ease that was required earlier in response to the
5 global financial market turmoil.

6 As the year 2000 drew to a close, economic activity slowed and consumer confidence
7 began to weaken. In two steps at the beginning and at the end of January 2001, the FOMC
8 reduced the Fed Funds rate by one percentage point. These actions brought the Fed Funds rate
9 to 5.50%. The FOMC described its actions as “a rapid and forceful response of monetary
10 policy” to eroding consumer and business confidence exemplified by weaker retail sales and
11 business spending on capital equipment and cut backs in manufacturing production.
12 Subsequently, on March 20, 2001, April 18, 2001, May 15, 2001, June 27, 2001, and August
13 21, 2001, the FOMC lowered the Fed Funds in steps consisting of three 50 basis points
14 decrements followed by two 25 basis points decrements. These actions took the Fed Funds rate
15 to 3.50%. The FOMC observed on August 21, 2001:

16 “Household demand has been sustained, but business profits and
17 capital spending continue to weaken and growth abroad is
18 slowing, weighing on the U.S. economy. The associated easing
19 of pressures on labor and product markets is expected to keep
20 inflation contained.

21
22 Although long-term prospects for productivity growth and the
23 economy remain favorable, the Committee continues to believe
24 that against the background of its long-run goals of price
25 stability and sustainable economic growth and of the
26 information currently available, the risks are weighted mainly
27 toward conditions that may generate economic weakness in the
28 foreseeable future.”

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1
2 After the terrorist attack on September 11, 2001, the FOMC made two additional 50 basis
3 points reductions in the Fed Funds rate. The first reduction occurred on September 17, 2001
4 and followed the four-day closure of the financial markets following the terrorist attacks. The
5 second reduction occurred at the October 2 meeting of the FOMC where it observed:

6 “The terrorist attacks have significantly heightened uncertainty
7 in an economy that was already weak. Business and household
8 spending as a consequence are being further damped.
9 Nonetheless, the long-term prospects for productivity growth
10 and the economy remain favorable and should become evident
11 once the unusual forces restraining demand abate.”
12

13 Afterward, the FOMC reduced the Fed Funds rate by 50 basis points on November 6, 2001 and
14 by 25 basis points on December 11, 2001. In total, short-term interest rates were reduced by
15 the FOMC eleven (11) times during the year 2001. These actions cut the Fed Funds rate by
16 4.75% and resulted in 1.75% for the Fed Funds rate.

17 In an attempt to deal with weakening fundamentals in the economy recovering from the
18 recession that began in March 2001, the FOMC provided a psychologically important one-half
19 percentage point reduction in the federal funds rate. The rate cut was twice as large as the
20 market expected, and brought the fed funds rate to 1.25% on November 6, 2002. The FOMC
21 stated that:

22 “The Committee continues to believe that an accommodative
23 stance of monetary policy, coupled with still-robust underlying
24 growth in productivity, is providing important ongoing support
25 to economic activity. However, incoming economic data have
26 tended to confirm that greater uncertainty, in part attributable to
27 heightened geopolitical risks, is currently inhibiting spending,
28 production, and employment. Inflation and inflation
29 expectations remain well contained.
30

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1 In these circumstances, the Committee believes that today's
2 additional monetary easing should prove helpful as the economy
3 works its way through this current soft spot. With this action,
4 the Committee believes that, against the background of its long-
5 run goals of price stability and sustainable economic growth and
6 of the information currently available, the risks are balanced
7 with respect to the prospects for both goals in the foreseeable
8 future."

9
10 As 2003 unfolded, there was a continuing expectation of lower yields on Treasury
11 securities. In fact, the yield on ten-year Treasury notes reached a 45-year low near the end of
12 the second quarter of 2003. For long-term Treasury bonds, those yields culminated with a
13 4.24% yield on June 13, 2003. Soon thereafter, the FOMC reduced the Fed Funds rate by 25
14 basis points on June 25, 2003. In announcing its action, the FOMC stated:

15 "The Committee continues to believe that an accommodative
16 stance of monetary policy, coupled with still robust underlying
17 growth in productivity, is providing important ongoing support to
18 economic activity. Recent signs point to a firming in spending,
19 markedly improved financial conditions, and labor and product
20 markets that are stabilizing. The economy, nonetheless, has yet
21 to exhibit sustainable growth. With inflationary expectations
22 subdued, the Committee judged that a slightly more expansive
23 monetary policy would add further support for an economy
24 which it expects to improve over time."

25
26 Thereafter, intermediate and long-term Treasury yields moved marketedly higher. Higher
27 yields on long-term Treasury bonds, which exceeded 5.00% can be traced to: (i) the market's
28 disappointment that the Fed Funds rate was not reduced below 1.00%, (ii) an indication that the
29 Fed will not use unconventional methods for implementing monetary policy, (iii) growing
30 confidence in a strengthening economy, and (iv) a Federal budget deficit that is projected to be
31 \$455 billion in 2003 (reported, subsequently, the actually deficit was \$374 billion) and \$475
32 billion in 2004 (revised subsequently, the estimated deficit is \$500 billion in 2004). All these

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1 factors significantly changed the sentiment in the bond market.

2 For the remainder of 2003, the FOMC continued with its balanced monetary policy,
3 thereby retaining the 1% Fed Funds rate. However, in 2004, the FOMC initiated a policy of
4 moving toward a more neutral Fed Funds rate (i.e., removing the bias of abnormal low rates).
5 On June 30, 2004, August 10, 2004, September 21, 2004, November 10, 2004, December 14,
6 2004, February 2, 2005, March 22, 2005, May 3, 2005, June 30, 2005, and August 9, 2005 the
7 FOMC increased the Fed Funds rate in ten 25 basis point increments. These policy actions are
8 widely interpreted as part of the process of moving toward a more neutral range for the Fed
9 Funds rate. In its August 9, 2005 press release, the FOMC stated:

10 “The Federal Open Market Committee decided today to raise
11 its target for the federal funds rate by 25 basis points to 3-1/2
12 percent.
13

14 The Committee believes that, even after this action, the stance
15 of monetary policy remains accommodative and, coupled with
16 robust underlying growth in productivity, is providing ongoing
17 support to economic activity. Aggregate spending, despite high
18 energy prices, appears to have strengthened since late winter,
19 and labor market conditions continue to improve gradually.
20 Core inflation has been relatively low in recent months and
21 longer-term inflation expectations remain well contained, but
22 pressures on inflation have stayed elevated.
23

24 The Committee perceives that, with appropriate monetary
25 policy action, the upside and downside risks to the attainment
26 of both sustainable growth and price stability should be kept
27 roughly equal. With underlying inflation expected to be
28 contained, the Committee believes that policy accommodation
29 can be removed at a pace that is likely to be measured.
30 Nonetheless, the Committee will respond to changes in
31 economic prospects as needed to fulfill its obligation to
32 maintain price stability.”
33
34

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Public Utility Bond Yields

The Risk Premium analysis of the cost of equity is represented by the combination of a firm's borrowing rate for long-term debt capital plus a premium that is required to reflect the additional risk associated with the equity of a firm as explained in Appendix H. Due to the senior nature of the long-term debt of a firm, its cost is lower than the cost of equity due to the prior claim which lenders have on the earnings and assets of a corporation.

As a generalization, all interest rates track to varying degrees of the benchmark yields established by the market for Treasury securities. Public utility bond yields usually reflect the underlying Treasury yield associated with a given maturity plus a spread to reflect the specific credit quality of the issuing public utility. Market sentiment can also have an influence on the spreads as described below. The spread in the yields on public utility bonds and Treasury bonds varies with market conditions, as does the relative level of interest rates at varying maturities shown by the yield curve.

Pages 1 and 2 of Schedule 8 provide the recent history of long-term public utility bond yields for the rating categories of Aa, A and Baa (no yields are shown for Aaa rated public utility bonds because this index has been discontinued). The top four rating categories of Aaa, Aa, A, and Baa are known as "investment grades" and are generally regarded as eligible for bank investments under commercial banking regulations. These investment grades are distinguished from "junk" bonds which have ratings of Ba and below.

A relatively long history of the spread between the yields on long-term A-rated public utility bonds and 20-year Treasury bonds is shown on page 3 of Schedule 8. There, it is shown that those spreads were about the one percentage during for the years 1994 through 1997. With

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1 the aversion to risk and flight to quality described earlier, a significant widening of the spread
2 in the yields between corporate (e.g., public utility) and Treasury bonds developed in 1998,
3 after an initial widening of the spread that began in the fourth quarter of 1997. The significant
4 widening of spreads in 1998 was unexpected by some technically savvy investors, as shown by
5 the debacle at the Long-Term Capital Management hedge fund. When Russia defaulted its debt
6 on August 17, some investors had to cover short positions when Treasury prices spiked upward.
7 Short covering by investors that guessed wrong on the relationship between corporate and
8 Treasury bonds also contributed to run-up in Treasury bond prices by increasing the demand
9 for them. This helped to contribute to a widening of the spreads between corporate and
10 Treasury bonds.

11 As shown on page 3 of Schedule 8, the spread in yields between A-rated public utility
12 bonds and 20-year Treasury bonds were about one percentage point prior to 1998, 1.32% in
13 1998, 1.42% in 1999, 2.01% in 2000, 2.13% in 2001, 1.94% in 2002, 1.62% in 2003, and
14 1.11% in 2004. As shown by the monthly data presented on pages 4 and 5 of Schedule 10, the
15 interest rate spread between the yields on 20-year Treasury bonds and A-rated public utility
16 bonds was 1.02 percentage points for the twelve-months ended June 2005. For the six- and
17 three-month periods ending June 2005, the yield spread was 0.98% and 0.97%, respectively.

Risk-Free Rate of Return in the CAPM

18
19 Regarding the risk-free rate of return (see Appendix H), pages 2 and 3 of Schedule 10
20 provide the yields on the broad spectrum of Treasury Notes and Bonds. Some practitioners of
21 the CAPM would advocate the use of short-term treasury yields (and some would argue for the
22 yields on 91-day Treasury Bills). Other advocates of the CAPM would advocate the use of

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1 longer-term treasury yields as the best measure of a risk-free rate of return. As Ibbotson has
2 indicated:

3 The Cost of Capital in a Regulatory Environment. When discounting
4 cash flows projected over a long period, it is necessary to discount
5 them by a long-term cost of capital. Additionally, regulatory
6 processes for setting rates often specify or suggest that the desired rate
7 of return for a regulated firm is that which would allow the firm to
8 attract and retain debt and equity capital over the long term. Thus, the
9 long-term cost of capital is typically the appropriate cost of capital to
10 use in regulated ratesetting. (Stocks, Bonds, Bills and Inflation - 1992
11 Yearbook, pages 118-119)
12

13 As indicated above, long-term Treasury bond yields represent the correct measure of the risk-
14 free rate of return in the traditional CAPM. Very short term yields on Treasury bills should be
15 avoided for several reasons. First, rates should be set on the basis of financial conditions that
16 will exist during the effective period of the proposed rates. Second, 91-day Treasury bill yields
17 are more volatile than longer-term yields and are greatly influenced by FOMC monetary policy,
18 political, and economic situations. Moreover, Treasury bill yields have been shown to be
19 empirically inadequate for the CAPM. Some advocates of the theory would argue that the risk-
20 free rate of return in the CAPM should be derived from quality long-term corporate bonds.

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RISK PREMIUM ANALYSIS

1
2 The cost of equity requires recognition of the risk premium required by common
3 equities over long-term corporate bond yields. In the case of senior capital, a company
4 contracts for the use of long-term debt capital at a stated coupon rate for a specific period of
5 time and in the case of preferred stock capital at a stated dividend rate, usually with provision
6 for redemption through sinking fund requirements. In the case of senior capital, the cost rate is
7 known with a high degree of certainty because the payment for use of this capital is a
8 contractual obligation, and the future schedule of payments is known. In essence, the investor-
9 expected cost of senior capital is equal to the realized return over the entire term of the issue,
10 absent default.

11 The cost of equity, on the other hand, is not fixed, but rather varies with investor
12 perception of the risk associated with the common stock. Because no precise measurement
13 exists as to the cost of equity, informed judgment must be exercised through a study of various
14 market factors which motivate investors to purchase common stock. In the case of common
15 equity, the realized return rate may vary significantly from the expected cost rate due to the
16 uncertainty associated with earnings on common equity. This uncertainty highlights the added
17 risk of a common equity investment.

18 As one would expect from traditional risk and return relationships, the cost of equity is
19 affected by expected interest rates. As noted in Appendix G, yields on long-term corporate
20 bonds traditionally consist of a real rate of return without regard to inflation, an increment to

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1 reflect investor perception of expected future inflation, the investment horizon shown by the
2 term of the issue until maturity, and the credit risk associated with each rating category.

3 The Risk Premium approach recognizes the required compensation for the more risky
4 common equity over the less risky secured debt position of a lender. The cost of equity stated
5 in terms of the familiar risk premium approach is:

$$k=i+RP$$

7 where, the cost of equity (" k ") is equal to the interest rate on long-term corporate debt (" i "),
8 plus an equity risk premium (" RP ") which represents the additional compensation for the
9 riskier common equity.

Equity Risk Premium

11 The equity risk premium is determined as the difference in the rate of return on debt
12 capital and the rate of return on common equity. Because the common equity holder has only a
13 residual claim on earnings and assets, there is no assurance that achieved returns on common
14 equities will equal expected returns. This is quite different from returns on bonds, where the
15 investor realizes the expected return during the entire holding period, absent default. It is for
16 this reason that common equities are always more risky than senior debt securities. There are
17 investment strategies available to bond portfolio managers that immunize bond returns against
18 fluctuations in interest rates because bonds are redeemed through sinking funds or at maturity,
19 whereas no such redemption is mandated for public utility common equities.

20 It is well recognized that the expected return on more risky investments will exceed the
21 required yield on less risky investments. Neither the possibility of default on a bond nor the

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1 maturity risk detracts from the risk analysis, because the common equity risk rate differential
2 (i.e., the investor-required risk premium) is always greater than the return components on a
3 bond. It should also be noted that the investment horizon is typically long-run for both
4 corporate debt and equity, and that the risk of default (i.e., corporate bankruptcy) is a concern
5 to both debt and equity investors. Thus, the required yield on a bond provides a benchmark or
6 starting point with which to track and measure the cost rate of common equity capital. There is
7 no need to segment the bond yield according to its components, because it is the total return
8 demanded by investors that is important for determining the risk rate differential for common
9 equity. This is because the complete bond yield provides the basis to determine the differential,
10 and as such, consistency requires that the computed differential must be applied to the complete
11 bond yield when applying the risk premium approach. To apply the risk rate differential to a
12 partial bond yield would result in a misspecification of the cost of equity because the computed
13 differential was initially determined by reference to the entire bond return.

14 The risk rate differential between the cost of equity and the yield on long-term corporate
15 bonds can be determined by reference to a comparison of holding period returns (here defined
16 as one year) computed over long time spans. This analysis assumes that over long periods of
17 time investors' expectations are on average consistent with rates of return actually achieved.
18 Accordingly, historical holding period returns must not be analyzed over an unduly short period
19 because near-term realized results may not have fulfilled investors' expectations. Moreover,
20 specific past period results may not be representative of investment fundamentals expected for
21 the future. This is especially apparent when the holding period returns include negative returns

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1 which are not representative of either investor requirements of the past or investor expectations
2 for the future. The short-run phenomenon of unexpected returns (either positive or negative)
3 demonstrates that an unduly short historical period would not adequately support a risk
4 premium analysis. It is important to distinguish between investors' motivation to invest, which
5 encompass positive return expectations, and the knowledge that losses can occur. No rational
6 investor would forego payment for the use of capital, or expect loss of principal, as a basis for
7 investing. Investors will hold cash rather than invest with the expectation of a loss.

8 Within these constraints, page 1 of Schedule 9 provides the historical holding period
9 returns for the S&P Public Utility Index which has been independently computed and the
10 historical holding period returns for the S&P Composite Index which have been reported in
11 Stocks, Bonds, Bills and Inflation published by Ibbotson & Associates. The tabulation begins
12 with 1928 because January 1928 is the earliest monthly dividend yield for the S&P Public
13 Utility Index. I have considered all reliable data for this study to avoid the introduction of a
14 particular bias to the results. The measurement of the common equity return rate differential is
15 based upon actual capital market performance using realized results. As a consequence, the
16 underlying data for this risk premium approach can be analyzed with a high degree of
17 precision. Informed professional judgment is required only to interpret the results of this study,
18 but not to quantify the component variables.

19 The risk rate differentials for all equities, as measured by the S&P Composite, are
20 established by reference to long-term corporate bonds. For public utilities, the risk rate
21 differentials are computed with the S&P Public Utilities as compared with public utility bonds.

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1 The measurement procedure used to identify the risk rate differentials consisted of
2 arithmetic means, geometric means, and medians for each series. Measures of the central
3 tendency of the results from the historical periods provide the best indication of representative
4 rates of return. In regulated ratesetting, the correct measure of the equity risk premium is the
5 arithmetic mean because a utility must expect to earn its cost of capital in each year in order to
6 provide investors with their long-term expectations. In other contexts, such as pension
7 determinations, compound rates of return, as shown by the geometric means, may be
8 appropriate. The median returns are also appropriate in ratesetting because they are a measure
9 of the central tendency of a single period rate of return. Median values have also been
10 considered in this analysis because they provide a return which divides the entire series of
11 annual returns in half and are representative of a return that symbolizes, in a meaningful way,
12 the central tendency of all annual returns contained within the analysis period. Medians are
13 regularly included in many investor-influencing publications.

14 As previously noted, the arithmetic mean provides the appropriate point estimate of the
15 risk premium. As further explained in Appendix H, the long-term cost of capital in rate cases
16 requires the use of the arithmetic means. To supplement my analysis, I have also used the rates
17 of return taken from the geometric mean and median for each series to provide the bounds of
18 the range to measure the risk rate differentials. This further analysis shows that when selecting
19 the midpoint from a range established with the geometric means and medians, the arithmetic
20 mean is indeed a reasonable measure for the long-term cost of capital. For the years 1928
21 through 2004, the risk premiums for each class of equity are:

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	<u>S&P Composite</u>	<u>S&P Public Utilities</u>
Arithmetic Mean	<u>5.86%</u>	<u>5.15%</u>
Geometric Mean	4.21%	3.05%
Median	<u>10.17%</u>	<u>6.61%</u>
Midpoint of Range	<u>7.19%</u>	<u>4.83%</u>
Average	<u>6.53%</u>	<u>4.99%</u>

The empirical evidence suggests that the common equity risk premium is higher for the S&P Composite Index compared to the S&P Public Utilities.

If, however, specific historical periods were also analyzed in order to match more closely historical fundamentals with current expectations, the results provided on page 2 of Schedule 9 should also be considered. One of these sub-periods included the 53-year period, 1952-2004. These years follow the historic 1951 Treasury-Federal Reserve Accord which affected monetary policy and the market for government securities.

A further investigation was undertaken to determine whether realignment has taken place subsequent to the historic 1973 Arab Oil embargo and during the deregulation of the financial markets. In each case, the public utility risk premiums were computed by using the arithmetic mean, and the geometric means and medians to establish the range shown by those values. The time periods covering the more recent periods 1974 through 2004 and 1979 through 2004 contain events subsequent to the initial oil shock and the advent of monetarism as Fed policy, respectively. For the 53-year, 31-year and 26-year periods, the public utility risk premiums were 5.75%, 4.85%, and 4.91% respectively, as shown by the average of the specific point-estimates and the midpoint of the ranges provided on page 2 of Schedule 9.

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CAPITAL ASSET PRICING MODEL

Modern portfolio theory provides a theoretical explanation of expected returns on portfolios of securities. The Capital Asset Pricing Model ("CAPM") attempts to describe the way prices of individual securities are determined in efficient markets where information is freely available and is reflected instantaneously in security prices. The CAPM states that the expected rate of return on a security is determined by a risk-free rate of return plus a risk premium which is proportional to the non-diversifiable (or systematic) risk of a security.

The CAPM theory has several unique assumptions that are not common to most other methods used to measure the cost of equity. As with other market-based approaches, the CAPM is an expectational concept. There has been significant academic research conducted that found that the empirical market line, based upon historical data, has a less steep slope and higher intercept than the theoretical market line of the CAPM. For equities with a beta less than 1.0, such as utility common stocks, the CAPM theoretical market line will underestimate the realistic expectation of investors in comparison with the empirical market line which shows that the CAPM may potentially misspecify investors' required return.

The CAPM considers changing market fundamentals in a portfolio context. The balance of the investment risk, or that characterized as unsystematic, must be diversified. Some argue that diversifiable (unsystematic) risk is unimportant to investors. But this contention is not completely justified because the business and financial risk of an individual company, including regulatory risk, are widely discussed within the investment community and therefore influence investors in regulated firms. In addition, I note that the CAPM assumes that

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1 through portfolio diversification, investors will minimize the effect of the unsystematic
2 (diversifiable) component of investment risk. Because it is not known whether the average
3 investor holds a well-diversified portfolio, the CAPM must also be used with other models of
4 the cost of equity.

5 To apply the traditional CAPM theory, three inputs are required: the beta coefficient
6 (β), a risk-free rate of return (R_f), and a market premium ($R_m - R_f$). The cost of equity
7 stated in terms of the CAPM is:

$$k = R_f + \beta (R_m - R_f)$$

9 As previously indicated, it is important to recognize that the academic research has
10 shown that the security market line was flatter than that predicted by the CAPM theory and it
11 had a higher intercept than the risk-free rate. These tests indicated that for portfolios with betas
12 less than 1.0, the traditional CAPM would understate the return for such stocks. Likewise, for
13 portfolios with betas above 1.0, these companies had lower returns than indicated by the
14 traditional CAPM theory. Once again, CAPM assumes that through portfolio diversification
15 investors will minimize the effect of the unsystematic (diversifiable) component of investment
16 risk. Therefore, the CAPM must also be used with other models of the cost of equity,
17 especially when it is not known whether the average public utility investor holds a well-
18 diversified portfolio.

Beta

20 The beta coefficient is a statistical measure which attempts to identify the non-
21 diversifiable (systematic) risk of an individual security and measures the sensitivity of rates of

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1 return on a particular security with general market movements. Under the CAPM theory, a
2 security that has a beta of 1.0 should theoretically provide a rate of return equal to the return
3 rate provided by the market. When employing stock price changes in the derivation of beta, a
4 stock with a beta of 1.0 should exhibit a movement in price which would track the movements
5 in the overall market prices of stocks. Hence, if a particular investment has a beta of 1.0, a one
6 percent increase in the return on the market will result, on average, in a one percent increase in
7 the return on the particular investment. An investment which has a beta less than 1.0 is
8 considered to be less risky than the market.

9 The beta coefficient (" β "), the one input in the CAPM application which specifically
10 applies to an individual firm, is derived from a statistical application which regresses the
11 returns on an individual security (dependent variable) with the returns on the market as a whole
12 (independent variable). The beta coefficients for utility companies typically describe a small
13 proportion of the total investment risk because the coefficients of determination (R^2) are low.

14 Page 1 of Schedule 10 provides the betas published by Value Line. By way of
15 explanation, the Value Line beta coefficient is derived from a "straight regression" based upon
16 the percentage change in the weekly price of common stock and the percentage change weekly
17 of the New York Stock Exchange Composite average using a five-year period. The raw
18 historical beta is adjusted by Value Line for the measurement effect resulting in overestimates
19 in high beta stocks and underestimates in low beta stocks. Value Line then rounds its betas to
20 the nearest .05 increment. Value Line does not consider dividends in the computation of its
21 betas.

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Market Premium

The final element necessary to apply the CAPM is the market premium. The market premium by definition is the rate of return on the total market less the risk-free rate of return ($R_m - R_f$). In this regard, the market premium in the CAPM has been calculated from the total return on the market of equities using forecast and historical data. The future market return is established with forecasts by Value Line using estimated dividend yields and capital appreciation potential.

With regard to the forecast data, I have relied upon the Value Line forecasts of capital appreciation and the dividend yield on the 1,700 stocks in the Value Line Survey. According to the July 1, 2005, edition of The Value Line Investment Survey Summary and Index, (see page 5 of Schedule 10) the total return on the universe of Value Line equities is:

	<u>Dividend</u> <u>Yield</u>	+	<u>Median</u> <u>Appreciation</u> <u>Potential</u>	=	<u>Median</u> <u>Total</u> <u>Return</u>
As of July 1, 2005	1.6%	+	10.67% ¹	=	12.27%

The tabulation shown above provides the dividend yield and capital gains yield of the companies followed by Value Line. Another measure of the total market return is provided by the DCF return on the S&P 500 Composite index. As shown below, that return is 12.51%.

¹ The estimated median appreciation potential is forecast to be 50% for 3 to 5 years hence. The annual capital gains yield at the midpoint of the forecast period is 10.67% (i.e., $1.50^{25} - 1$).

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DCF Result for the S&P 500 Composite							
D/P	(1+.5g)	+	g	=	k
1.80%	(1.05305)	+	10.61%	=	12.51%
where:	Price (P)	at	30-Jun-2005	=	1191.33		
	Dividend (D)	for	2nd Qtr '05	=	5.36		
	Dividend (D)		annualized	=	21.44		
	Growth (g)		First Call EpS	=	10.61%		

1 Using these indicators, the total market return is 12.39% (12.27% + 12.51% = 24.78% ÷ 2)
 2 using both the Value Line and S&P derived returns. With the 12.39% forecast market return
 3 and the 5.75% risk-free rate of return, a 6.64% (12.39% - 5.75%) market premium would be
 4 indicated using forecast market data.

5 With regard to the historical data, I provided the rates of return from long-term
 6 historical time periods that have been widely circulated among the investment and academic
 7 community over the past several years, as shown on page 6 of Schedule 10. These data are
 8 published by Ibbotson Associates in its Stocks, Bonds, Bills and Inflation ("SBBI"). From the
 9 data provided on page 6 of Schedule 12, I calculate a market premium using the common stock
 10 arithmetic mean returns of 12.4% less government bond arithmetic mean returns of 5.8%. For
 11 the period 1926-2004, the market premium was 6.6% (12.4% - 5.8%). I should note that the
 12 arithmetic mean must be used in the CAPM because it is a single period model. It is further
 13 confirmed by Ibbotson who has indicated:

14 *Arithmetic Versus Geometric Differences*
 15 For use as the expected equity risk premium in the CAPM, the
 16 *arithmetic* or *simple difference* of the *arithmetic* means of stock
 17 market returns and riskless rates is the relevant number. This is
 18 because the CAPM is an additive model where the cost of
 19 capital is the sum of its parts. Therefore, the CAPM expected

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1 equity risk premium must be derived by arithmetic, *not*
2 *geometric*, subtraction.
3

4 *Arithmetic Versus Geometric Means*

5 The expected equity risk premium should always be calculated
6 using the arithmetic mean. The arithmetic mean is the rate of
7 return which, when compounded over multiple periods, gives
8 the mean of the probability distribution of ending wealth
9 values. This makes the arithmetic mean return appropriate for
10 computing the cost of capital. The discount rate that equates
11 expected (mean) future values with the present value of an
12 investment is that investment's cost of capital. The logic of
13 using the discount rate as the cost of capital is reinforced by
14 noting that investors will discount their (mean) ending wealth
15 values from an investment back to the present using the
16 arithmetic mean, for the reason given above. They will
17 therefore require such an expected (mean) return prospectively
18 (that is, in the present looking toward the future) to commit
19 their capital to the investment. (Stocks, Bonds, Bills and
20 Inflation - 1996 Yearbook, pages 153-154)
21

22 For the CAPM, a market premium of 6.62% ($6.6\% + 6.64\% = 13.24\% \div 2$) would be
23 reasonable which is the average of the 6.6% using historical data and a market premium of
24 6.64% using forecasts.

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COMPARABLE EARNINGS APPROACH

Value Line's analysis of the companies that it follows includes a wide range of financial and market variables, including nine items that provide ratings for each company. From these nine items, one category has been removed dealing with industry performance because, under approach employed, the particular business type is not significant. In addition, two categories have been ignored that deal with estimates of current earnings and dividends because they are not useful for comparative purposes. The remaining six categories provide relevant measures to establish comparability. The definitions for each of the six criteria (from the Value Line Investment Survey - Subscriber Guide) follow:

Timeliness Rank

The rank for a stock's probable relative market performance in the year ahead. Stocks ranked 1 (Highest) or 2 (Above Average) are likely to outpace the year-ahead market. Those ranked 4 (Below Average) or 5 (Lowest) are not expected to outperform most stocks over the next 12 months. Stocks ranked 3 (Average) will probably advance or decline with the market in the year ahead. Investors should try to limit purchases to stocks ranked 1 (Highest) or 2 (Above Average) for Timeliness.

Safety Rank

A measure of potential risk associated with individual common stocks rather than large diversified portfolios (for which Beta is good risk measure). Safety is based on the stability of price, which includes sensitivity to the market (see Beta) as well as the stock's inherent volatility, adjusted for trend and other factors including company size, the penetration of its markets, product market volatility, the degree of financial leverage, the earnings quality, and the overall condition of the balance sheet. Safety Ranks range from 1 (Highest) to 5 (Lowest).

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1 Conservative investors should try to limit purchases to equities
2 ranked 1 (Highest) or 2 (Above Average) for Safety.

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Financial Strength

The financial strength of each of the more than 1,600 companies in the VS II data base is rated relative to all the others. The ratings range from A++ to C in nine steps. (For screening purposes, think of an A rating as "greater than" a B). Companies that have the best relative financial strength are given an A++ rating, indicating an ability to weather hard times better than the vast majority of other companies. Those who don't quite merit the top rating are given an A+ grade, and so on. A rating as low as C++ is considered satisfactory. A rating of C+ is well below average, and C is reserved for companies with very serious financial problems. The ratings are based upon a computer analysis of a number of key variables that determine (a) financial leverage, (b) business risk, and (c) company size, plus the judgment of Value Line's analysts and senior editors regarding factors that cannot be quantified across-the-board for companies. The primary variables that are indexed and studied include equity coverage of debt, equity coverage of intangibles, "quick ratio", accounting methods, variability of return, fixed charge coverage, stock price stability, and company size.

Price Stability Index

An index based upon a ranking of the weekly percent changes in the price of the stock over the last five years. The lower the standard deviation of the changes, the more stable the stock. Stocks ranking in the top 5% (lowest standard deviations) carry a Price Stability Index of 100; the next 5%, 95; and so on down to 5. One standard deviation is the range around the average weekly percent change in the price that encompasses about two thirds of all the weekly percent change figures over the last five years. When the range is wide, the standard deviation is high and the stock's Price Stability Index is low.

Beta

A measure of the sensitivity of the stock's price to overall fluctuations in the New York Stock Exchange Composite Average. A Beta of 1.50 indicates that a stock tends to rise (or fall) 50% more than the New York Stock Exchange Composite

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1 Average. Use Beta to measure the stock market risk inherent
2 in any diversified portfolio of, say, 15 or more companies.
3 Otherwise, use the Safety Rank, which measures total risk
4 inherent in an equity, including that portion attributable to
5 market fluctuations. Beta is derived from a least squares
6 regression analysis between weekly percent changes in the
7 price of a stock and weekly percent changes in the NYSE
8 Average over a period of five years. In the case of shorter
9 price histories, a smaller time period is used, but two years is
10 the minimum. The Betas are periodically adjusted for their
11 long-term tendency to regress toward 1.00.

Technical Rank

12
13
14
15 A prediction of relative price movement, primarily over the
16 next three to six months. It is a function of price action relative
17 to all stocks followed by Value Line. Stocks ranked 1
18 (Highest) or 2 (Above Average) are likely to outpace the
19 market. Those ranked 4 (Below Average) or 5 (Lowest) are
20 not expected to outperform most stocks over the next six
21 months. Stocks ranked 3 (Average) will probably advance or
22 decline with the market. Investors should use the Technical
23 and Timeliness Ranks as complements to one another.

THE COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

IN THE MATTER OF THE REVISION OF RATES

Filed by

BOSTON EDISON COMPANY
COMMONWEALTH ELECTRIC COMPANY
CAMBRIDGE ELECTRIC LIGHT COMPANY

D/B/A NSTAR ELECTRIC

D.T.E. 05-85

Exhibit to Accompany

the

Direct Testimony

of

Paul R. Moul
Managing Consultant
P. Moul & Associates

Concerning
Cost of Equity

Boston Edison Company
Commonwealth Electric Company
Cambridge Electric Light Company
D/B/A NSTAR Electric

Index of Schedules

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Boston Edison Company
Summary Overall Rate of Return

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
Long-Term Debt	40.35%	5.75%	2.32%
Preferred & Preference Stock	2.13%	4.56%	0.10%
Common Equity	<u>57.52%</u>	11.50%	<u>6.61%</u>
Total	<u>100.00%</u>		<u>9.03%</u>

Indicated levels of fixed charge coverage assuming that the Company could actually achieve its overall rate of return:

Pre-tax coverage of interest expense based upon a 39.225% composite federal and state income tax rate (13.36% ÷ 2.32%)	5.76 x
Post-tax coverage of interest expense (9.03% ÷ 2.32%)	3.89 x
Overall coverage of interest expense and preferred stock dividends (9.03% ÷ 2.42%)	3.73 x

Commonwealth Electric Company
Summary Overall Rate of Return

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
Long-Term Debt	50.00%	8.64%	4.32%
Common Equity	<u>50.00%</u>	11.50%	<u>5.75%</u>
Total	<u>100.00%</u>		<u>10.07%</u>

Indicated levels of fixed charge coverage assuming that the Company could actually achieve its overall rate of return:

Pre-tax coverage of interest expense based upon a 39.225% composite federal and state income tax rate (13.78% ÷ 4.32%)	3.19 x
Post-tax coverage of interest expense (10.07% ÷ 4.32%)	2.33 x

Cambridge Electric Light Company
Summary Overall Rate of Return

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
Long-Term Debt	50.00%	7.94%	3.97%
Common Equity	<u>50.00%</u>	11.50%	<u>5.75%</u>
Total	<u>100.00%</u>		<u>9.72%</u>

Indicated levels of fixed charge coverage assuming that the Company could actually achieve its overall rate of return:

Pre-tax coverage of interest expense based upon a 39.225% composite federal and state income tax rate (13.43% ÷ 3.97%)	3.38 x
Post-tax coverage of interest expense (9.72% ÷ 3.97%)	2.45 x

NSTAR Electric Companies
Capitalization and Financial Statistics
1999-2003, Inclusive

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	
	(Millions of Dollars)					
Amount of Capital Employed						
Permanent Capital	\$ 3,008.9	\$ 2,806.9	\$ 2,819.5	\$ 2,577.1	\$ 2,491.8	
Short-Term Debt	\$ 420.0	\$ 586.4	\$ 570.7	\$ 795.8	\$ 816.0	
Total Capital	<u>\$ 3,429.0</u>	<u>\$ 3,393.3</u>	<u>\$ 3,390.2</u>	<u>\$ 3,373.0</u>	<u>\$ 3,307.8</u>	
Capital Structure Ratios						
Based on Permanent Capital:						Average
Long-Term Debt	39.7%	38.4%	38.9%	27.0%	29.0%	34.6%
Preferred Stock	1.4%	1.5%	1.5%	1.7%	3.7%	2.0%
Common Equity	58.9%	60.0%	59.6%	71.3%	67.2%	63.4%
	<u>100.0%</u>	<u>99.9%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>99.9%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	47.1%	49.1%	49.2%	44.2%	46.5%	47.2%
Preferred Stock	1.3%	1.3%	1.3%	1.3%	2.8%	1.6%
Common Equity	51.7%	49.7%	49.5%	54.5%	50.7%	51.2%
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity	10.0%	10.3%	9.4%	10.2%	11.5%	10.3%
Operating Ratio (1)	85.4%	84.5%	85.2%	85.1%	81.1%	84.3%
Coverage incl. AFUDC (2)						
Pre-tax: All Interest Charges	4.20 x	3.88 x	3.51 x	3.78 x	3.19 x	3.71 x
Post-tax: All Interest Charges	2.92 x	2.70 x	2.49 x	2.68 x	2.30 x	2.62 x
Overall Coverage: All Int. & Pfd. Div.	2.86 x	2.65 x	2.45 x	2.55 x	2.21 x	2.54 x
Coverage excl. AFUDC (3)						
Pre-tax: All Interest Charges	4.19 x	3.86 x	3.49 x	3.76 x	3.17 x	3.69 x
Post-tax: All Interest Charges	2.91 x	2.69 x	2.47 x	2.67 x	2.29 x	2.61 x
Overall Coverage: All Int. & Pfd. Div.	2.85 x	2.64 x	2.43 x	2.54 x	2.19 x	2.53 x
Quality of Earnings & Cash Flow						
AFUDC/Income Avail. for Common Equity	0.5%	0.9%	1.5%	0.8%	1.5%	1.0%
Effective Income Tax Rate	39.9%	40.8%	40.6%	39.4%	40.5%	40.2%
Internal Cash Generation/Construction (4)	250.8%	12.9%	104.0%	119.1%	151.5%	127.7%
Gross Cash Flow/ Avg. Total Debt(5)	46.7%	12.0%	25.9%	19.0%	19.4%	24.6%
Gross Cash Flow Interest Coverage(6)	9.20 x	2.53 x	4.15 x	3.25 x	2.20 x	4.27 x
Common Dividend Coverage (7)	9.02 x	1.19 x	4.62 x	3.79 x	15.64 x	6.85 x

See Page 2 for Notes.

NSTAR Electric Companies
Capitalization and Financial Statistics
2000-2004, Inclusive

Notes:

- (1) Total operating expenses, maintenance, depreciation and taxes other than income as a percentage of operating revenues.
- (2) Coverage calculations represent the number of times available earnings including AFUDC (allowance for funds used during construction), as reported in its entirety, cover fixed charges.
- (3) Coverage calculations represent the number of times available earnings excluding AFUDC (allowance for funds used during construction), as reported in its entirety, cover fixed charges.
- (4) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally generated funds from operations after payment of all cash dividends.
- (5) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less AFUDC) as a percentage of average total debt.
- (6) Gross Cash Flow plus interest charges divided by interest charges.
- (7) Common dividend coverage is the relationship of internally generated funds from operations after payment of preferred stock dividends to common dividends paid.

Source of Information: Company provided data

Electric Group
Capitalization and Financial Statistics (1)
2000-2004, Inclusive

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	
	(Millions of Dollars)					
Amount of Capital Employed						
Permanent Capital	\$ 3,962.0	\$ 3,850.8	\$ 3,781.5	\$ 3,458.3	\$ 3,232.8	
Short-Term Debt	\$ 81.4	\$ 99.2	\$ 87.5	\$ 162.9	\$ 305.1	
Total Capital	<u>\$ 4,043.4</u>	<u>\$ 3,950.0</u>	<u>\$ 3,869.0</u>	<u>\$ 3,621.2</u>	<u>\$ 3,537.9</u>	
Market-Based Financial Ratios						<u>Average</u>
Price-Earnings Multiple	17 x	15 x	17 x	11 x	13 x	15 x
Market/Book Ratio	149.3%	138.6%	137.7%	138.6%	135.9%	140.0%
Dividend Yield	4.6%	5.0%	5.2%	5.0%	5.2%	5.0%
Dividend Payout Ratio	79.5%	76.0%	96.3%	52.5%	60.4%	72.9%
Capital Structure Ratios						
Based on Permanent Capital:						
Long-Term Debt	50.9%	52.6%	55.2%	54.0%	51.8%	52.9%
Preferred Stock	2.3%	2.0%	2.3%	3.3%	3.8%	2.7%
Common Equity	<u>46.8%</u>	<u>45.4%</u>	<u>42.5%</u>	<u>42.7%</u>	<u>44.5%</u>	<u>44.4%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	51.6%	53.7%	56.0%	55.3%	55.9%	54.5%
Preferred Stock	2.3%	2.0%	2.3%	3.3%	3.4%	2.7%
Common Equity	<u>46.1%</u>	<u>44.3%</u>	<u>41.8%</u>	<u>41.4%</u>	<u>40.6%</u>	<u>42.8%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity	9.1%	9.8%	9.2%	5.0%	10.3%	8.7%
Operating Ratio (2)	88.9%	88.2%	88.1%	89.9%	87.5%	88.5%
Coverage incl. AFUDC (3)						
Pre-tax: All Interest Charges	3.08 x	2.89 x	2.75 x	2.29 x	2.79 x	2.76 x
Post-tax: All Interest Charges	2.33 x	2.19 x	2.10 x	1.75 x	2.09 x	2.09 x
Overall Coverage: All Int. & Pfd. Div.	2.28 x	2.14 x	2.03 x	1.66 x	2.00 x	2.02 x
Coverage excl. AFUDC (3)						
Pre-tax: All Interest Charges	3.04 x	2.85 x	2.73 x	2.27 x	2.76 x	2.73 x
Post-tax: All Interest Charges	2.28 x	2.16 x	2.08 x	1.73 x	2.07 x	2.06 x
Overall Coverage: All Int. & Pfd. Div.	2.24 x	2.10 x	2.01 x	1.64 x	1.98 x	1.99 x
Quality of Earnings & Cash Flow						
AFUDC/Income Avail. for Common Equity	3.4%	4.0%	2.1%	-21.2%	-17.5%	-5.8%
Effective Income Tax Rate	32.9%	35.5%	37.2%	44.4%	-391.4%	-48.3%
Internal Cash Generation/Construction (4)	118.5%	122.2%	119.4%	139.4%	146.2%	129.1%
Gross Cash Flow/ Avg. Total Debt(5)	21.6%	20.5%	19.6%	20.2%	20.2%	20.4%
Gross Cash Flow Interest Coverage(6)	4.44 x	4.01 x	3.59 x	3.71 x	3.55 x	3.86 x
Common Dividend Coverage (7)	4.34 x	4.40 x	4.22 x	5.53 x	4.70 x	4.64 x

See Page 2 for Notes.

Electric Group
Capitalization and Financial Statistics
2000-2004, Inclusive

Notes:

- (1) All capitalization and financial statistics for the group are the arithmetic average of the achieved results for each individual company in the group.
- (2) Total operating expenses, maintenance, depreciation and taxes other than income as a percentage of operating revenues.
- (3) Coverage calculations represent the number of times available earnings including AFUDC (allowance for funds used during construction), as reported in its entirety, cover fixed charges.
- (4) Coverage calculations represent the number of times available earnings excluding AFC (allowance for funds used during construction), as reported in its entirety, cover fixed charges.
- (5) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally-generated funds from operations after payment of all cash dividends.
- (6) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income tax and investment tax credits, less total AFUDC) as a percentage of average total debt.
- (7) Gross Cash Flow plus interest charges divided by interest charges.
- (8) Common dividend coverage is the relationship of internally-generated funds from operations after payment of preferred stock dividends to common dividends paid.

Basis of Selection

The Electric Group includes companies that (i) are engaged in the electric delivery business, (ii) have publicly-traded common stock, (iii) are contained in The Value Line Investment Survey, (iv) operate in the Northeastern and Southeastern regions of the U.S., (v) have not cut or omitted their dividend since 2000, (vi) are not currently the target of a merger or acquisition, and (vii) have at least 70% of their assets represented by electric operations.

Ticker	Company	Corporate Credit Ratings		Stock Traded	S&P Stock Ranking	Value Line Beta
		Moody's	S&P			
CHG	CH Energy Group	A2	A	NYSE	A-	0.80
CV	Central Vermont P.S.	-	BB+	NYSE	B	0.50
ED	Consolidated Edison	A1	A	NYSE	B+	0.60
DQE	Duquesne Light Holdings	Baa2	BBB	NYSE	B	0.80
EAS	Energy East Corp.	Baa1	BBB+	NYSE	B+	0.85
GMP	Green Mountain Power	Baa1	BBB	NYSE	B	0.60
NU	Northeast Utilities	Baa1	BBB	NYSE	B	0.80
NST	NSTAR	A1	A	NYSE	B+	0.70
UIL	UIL Holdings	Baa2	-	NYSE	B+	0.80
Average		<u>Baa1</u>	<u>BBB</u>		<u>B+</u>	<u>0.72</u>

Note: Ratings are those of utility subsidiaries

Source of Information: Utility COMPUSTAT

Standard & Poor's Public Utilities
Capitalization and Financial Statistics (1)
2000-2004, Inclusive

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	
			(Millions of Dollars)			
Amount of Capital Employed						
Permanent Capital	\$ 14,204.1	\$ 14,494.4	\$ 14,111.6	\$ 13,848.1	\$ 11,801.3	
Short-Term Debt	\$ 274.2	\$ 259.4	\$ 936.6	\$ 1,195.1	\$ 1,649.0	
Total Capital	<u>\$ 14,478.3</u>	<u>\$ 14,753.8</u>	<u>\$ 15,048.2</u>	<u>\$ 15,043.2</u>	<u>\$ 13,450.3</u>	
Market-Based Financial Ratios						<u>Average</u>
Price-Earnings Multiple	17 x	13 x	15 x	17 x	18 x	16 x
Market/Book Ratio	181.7%	147.9%	153.9%	194.3%	188.8%	173.3%
Dividend Yield	3.7%	4.0%	4.8%	3.9%	4.7%	4.2%
Dividend Payout Ratio	69.5%	59.6%	72.8%	61.6%	82.6%	69.2%
Capital Structure Ratios						
Based on Permanent Capital:						
Long-Term Debt	59.2%	61.1%	61.7%	58.8%	57.5%	59.7%
Preferred Stock	1.9%	1.9%	2.5%	3.0%	2.7%	2.4%
Common Equity	<u>38.9%</u>	<u>36.9%</u>	<u>35.8%</u>	<u>38.2%</u>	<u>39.8%</u>	<u>37.9%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	60.6%	62.5%	64.6%	62.8%	63.0%	62.7%
Preferred Stock	1.9%	1.9%	2.4%	2.7%	2.4%	2.3%
Common Equity	<u>37.5%</u>	<u>35.6%</u>	<u>33.1%</u>	<u>34.5%</u>	<u>34.6%</u>	<u>35.1%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity	10.5%	9.7%	6.9%	14.2%	8.3%	9.9%
Operating Ratio (2)	82.2%	84.6%	85.1%	85.5%	86.8%	84.8%
Coverage incl. AFUDC (3)						
Pre-tax: All Interest Charges	2.86 x	2.49 x	2.28 x	2.81 x	2.55 x	2.60 x
Post-tax: All Interest Charges	2.30 x	2.05 x	1.89 x	2.19 x	2.01 x	2.09 x
Overall Coverage: All Int. & Pfd. Div.	2.27 x	2.02 x	1.85 x	2.14 x	1.95 x	2.05 x
Coverage excl. AFUDC (3)						
Pre-tax: All Interest Charges	2.83 x	2.45 x	2.23 x	2.78 x	2.52 x	2.56 x
Post-tax: All Interest Charges	2.27 x	2.01 x	1.85 x	2.15 x	1.98 x	2.05 x
Overall Coverage: All Int. & Pfd. Div.	2.24 x	1.98 x	1.81 x	2.10 x	1.92 x	2.01 x
Quality of Earnings & Cash Flow						
AFUDC/Income Avail. for Common Equity	2.2%	1.5%	2.6%	2.0%	5.3%	2.7%
Effective Income Tax Rate	26.4%	41.5%	29.3%	30.6%	35.6%	32.7%
Internal Cash Generation/Construction (4)	130.7%	128.7%	93.0%	95.9%	87.0%	107.1%
Gross Cash Flow/ Avg. Total Debt(5)	19.2%	19.3%	17.4%	17.7%	17.7%	18.3%
Gross Cash Flow Interest Coverage(6)	4.16 x	4.19 x	3.86 x	3.58 x	3.58 x	3.87 x
Common Dividend Coverage (7)	5.95 x	5.65 x	4.34 x	4.56 x	4.28 x	4.96 x

See Page 2 for Notes.

Standard & Poor's Public Utilities
Capitalization and Financial Statistics
2000-2004, Inclusive

Notes:

- (1) All capitalization and financial statistics for the group are the arithmetic average of the achieved results for each individual company in the group.
- (2) Total operating expenses, maintenance, depreciation and taxes other than income taxes as a percent of operating revenues.
- (3) Coverage calculations represent the number of times available earnings, both including and excluding AFUDC (allowance for funds used during construction) as reported in its entirety, cover fixed charges.
- (4) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally-generated funds from operations after payment of all cash dividends divided by gross construction expenditures.
- (5) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) as a percentage of average total debt.
- (6) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) plus interest charges, divided by interest charges.
- (7) Common dividend coverage is the relationship of internally-generated funds from operations after payment of preferred stock dividends to common dividends paid.

Source of Information: Annual Reports to Shareholders
Utility COMPUSTAT

Standard & Poor's Public Utilities

Company Identities (1)

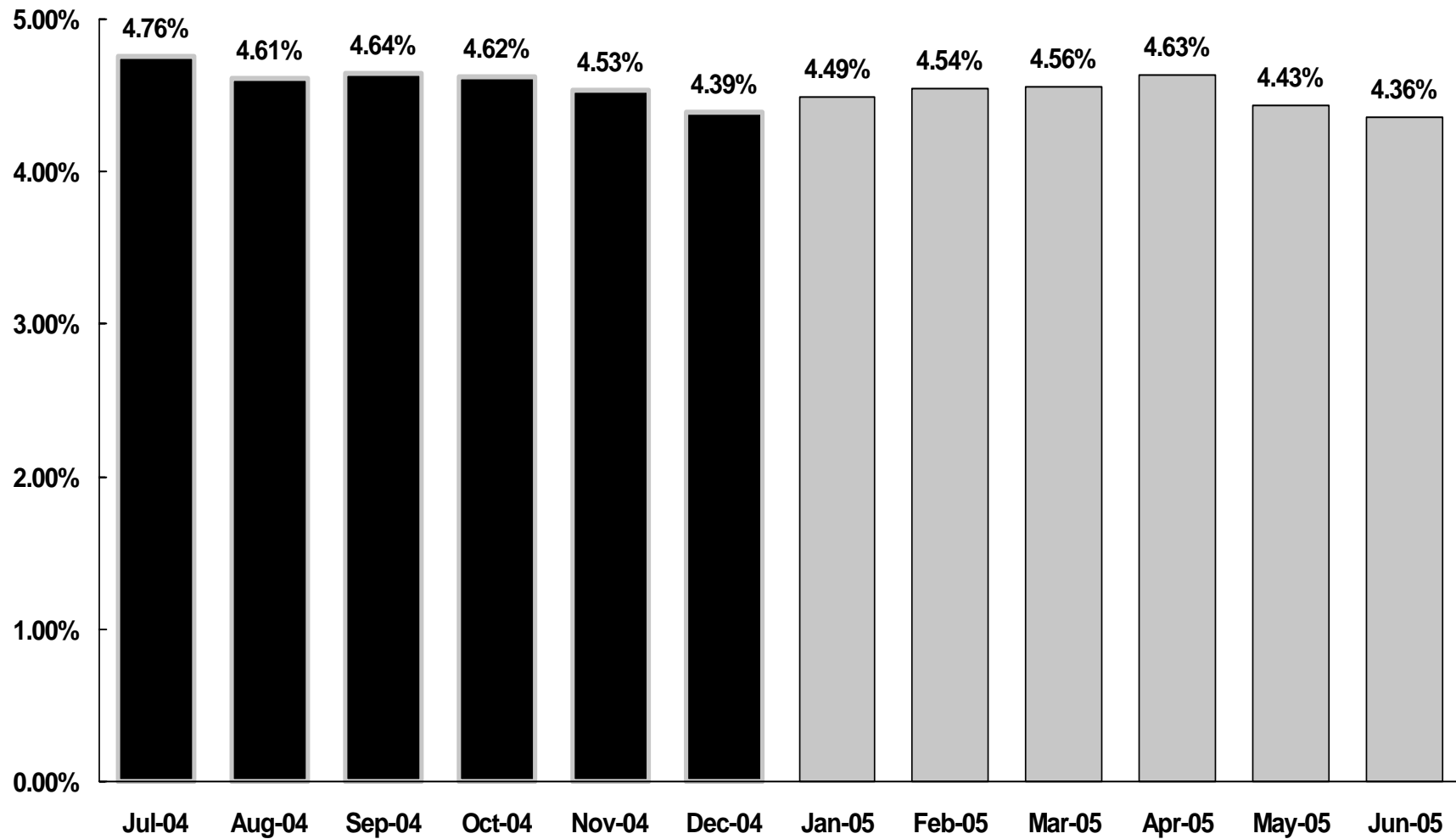
	Ticker	Credit Rating (2)		Common Stock Traded	S&P Stock Ranking	Value Line Beta
		Moody's	S&P			
Allegheny Energy	AYE	Ba1	BB-	NYSE	A-	1.60
Ameren Corporation	AEE	A2	A-	NYSE	A-	0.75
American Electric Power	AEP	Baa2	BBB+	NYSE	B+	1.15
CenterPoint Energy	CNP	Baa3	BBB	NYSE	B	0.55
CINergy Corp.	CIN	Baa1	BBB+	NYSE	B	0.80
CMS Energy	CMS	Ba1	BB	NYSE	B	1.30
Consolidated Edison	ED	A1	A+	NYSE	A-	0.60
Constellation Energy Group	CEG	A2	A-	NYSE	A-	0.85
DTE Energy Co.	DTE	Baa1	BBB+	NYSE	B+	0.70
Dominion Resources	D	A3	A-	NYSE	B	0.85
Duke Energy	DUK	A3	A-	NYSE	A-	1.10
Edison Int'l	EIX	Ba3	BB	NYSE	B	1.05
El Paso Corp.	EP	B1	BB	NYSE	B+	1.85
Entergy Corp.	ETR	Baa3	BBB	NYSE	B	0.75
Exelon Corp.	EXC	A3	A-	NYSE	B	0.70
FPL Group	FPL	A1	A	NYSE	B+	0.70
FirstEnergy Corp.	FE	Baa2	BBB	NYSE	B+	0.75
Keyspan Energy	KSE	A3	A	NYSE	B+	0.80
Kinder Morgan	KMI	Baa2	BBB	NYSE	B	0.80
NICOR Inc.	GAS	Aa2	AA	NYSE	B+	1.05
NiSource Inc.	NI	Baa2	BBB	NYSE	A	0.75
PG&E Corp.	PCG	Caa2	D	NYSE	B	1.00
PPL Corp.	PPL	Baa1	A-	NYSE	B+	0.95
Peoples Energy	PGL	Aa3	A-	NYSE	B+	0.80
Pinnacle West Capital	PNW	Baa1	BBB	NYSE	A-	0.85
Progress Energy, Inc.	PGN	Baa1	BBB+	NYSE	A-	0.80
Public Serv. Enterprise Inc.	PEG	Baa1	BBB	NYSE	B+	0.85
Sempra Energy	SRE	A2	A+	NYSE	NR	0.90
Southern Co.	SO	A2	A	NYSE	A-	0.65
TECO Energy	TE	A2	BBB	NYSE	A	0.90
TXU CORP	TXU	Baa3	BBB	NYSE	B	1.00
Williams Cos.	WMB	Caa1	B+	NYSE	B	2.40
Xcel Energy Inc	XEL	Baa1	BBB+	NYSE	B+	0.80
Average for S&P Utilities		<u>Baa2</u>	<u>BBB</u>		<u>B+</u>	<u>0.95</u>

Note: * (1) Includes companies contained in S&P Utility Compustat. AES Corp., Calpine Corp., and Dynegy, Inc. are not included.

(2) Ratings are those of utility subsidiaries

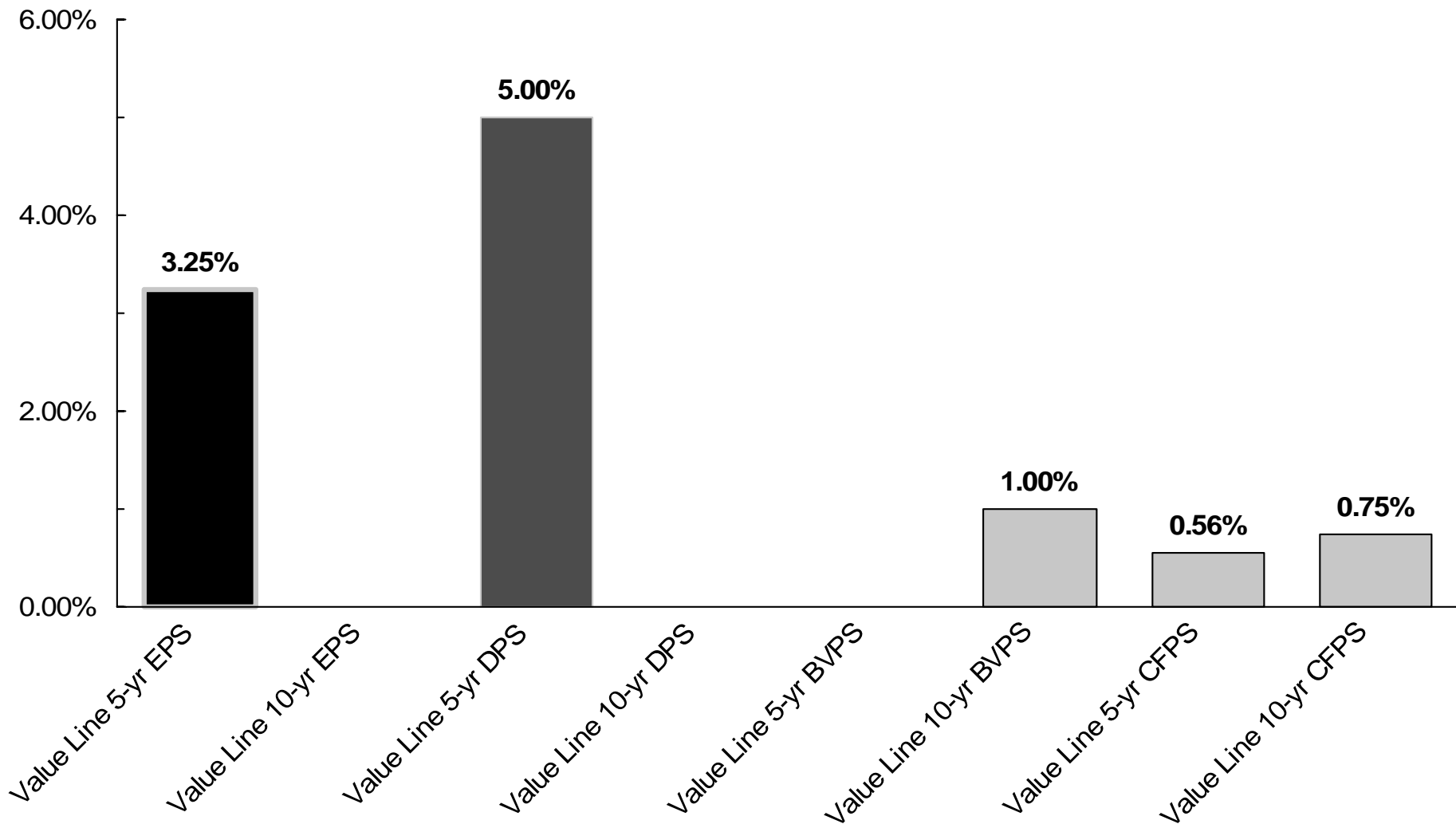
Source of Information: Moody's Investors Service
Standard & Poor's Corporation
Standard & Poor's Stock Guide
Value Line Investment Survey for Windows

Electric Group Monthly Dividend Yields



Electric Group

Historical Growth Rates

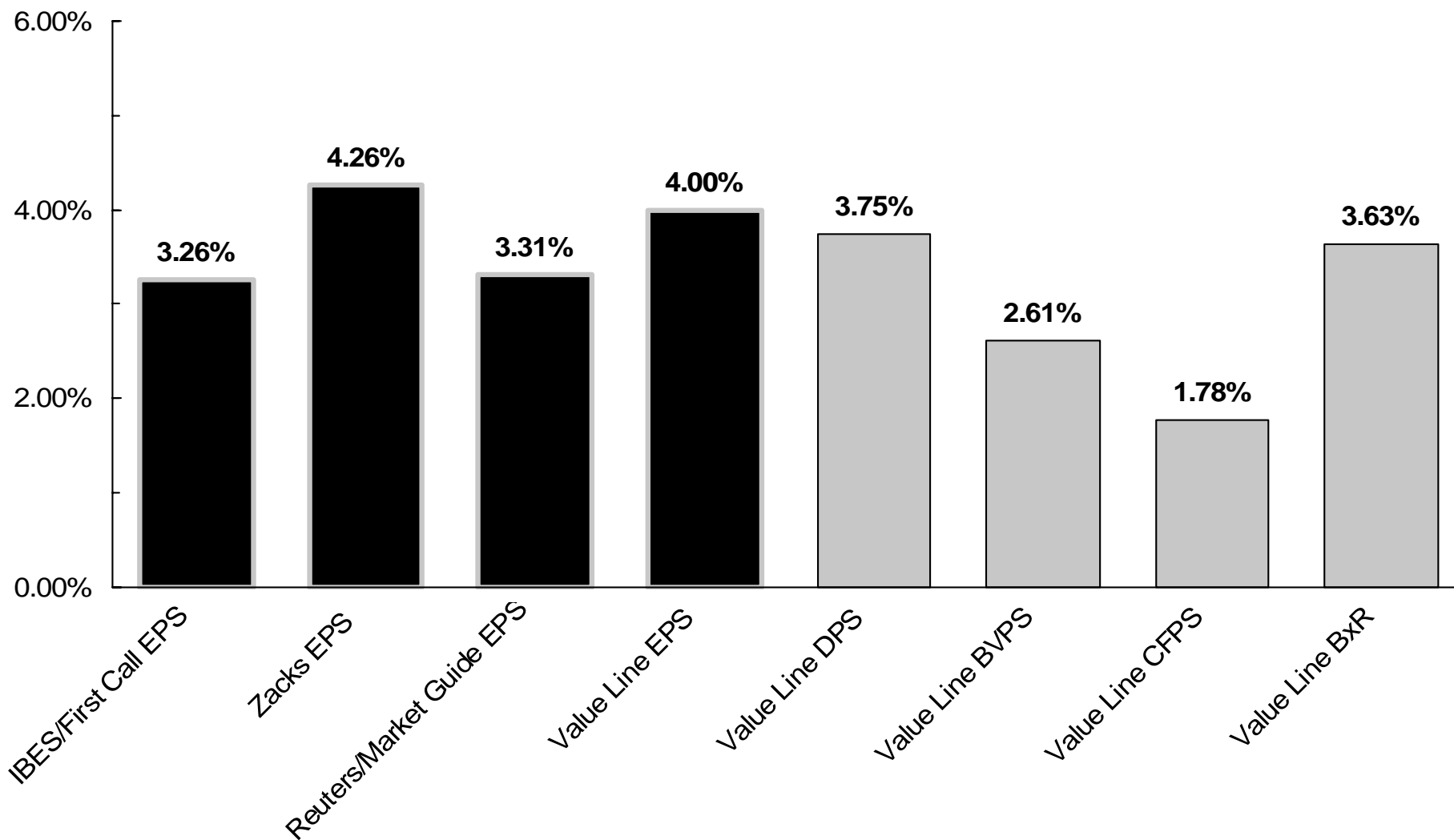


Earnings per Share=EPS
Dividends per Share=DPS
Percent Retained to Common Equity=BxR

Book Values per Share=BVPS
Cash Flow per Share=CFPS

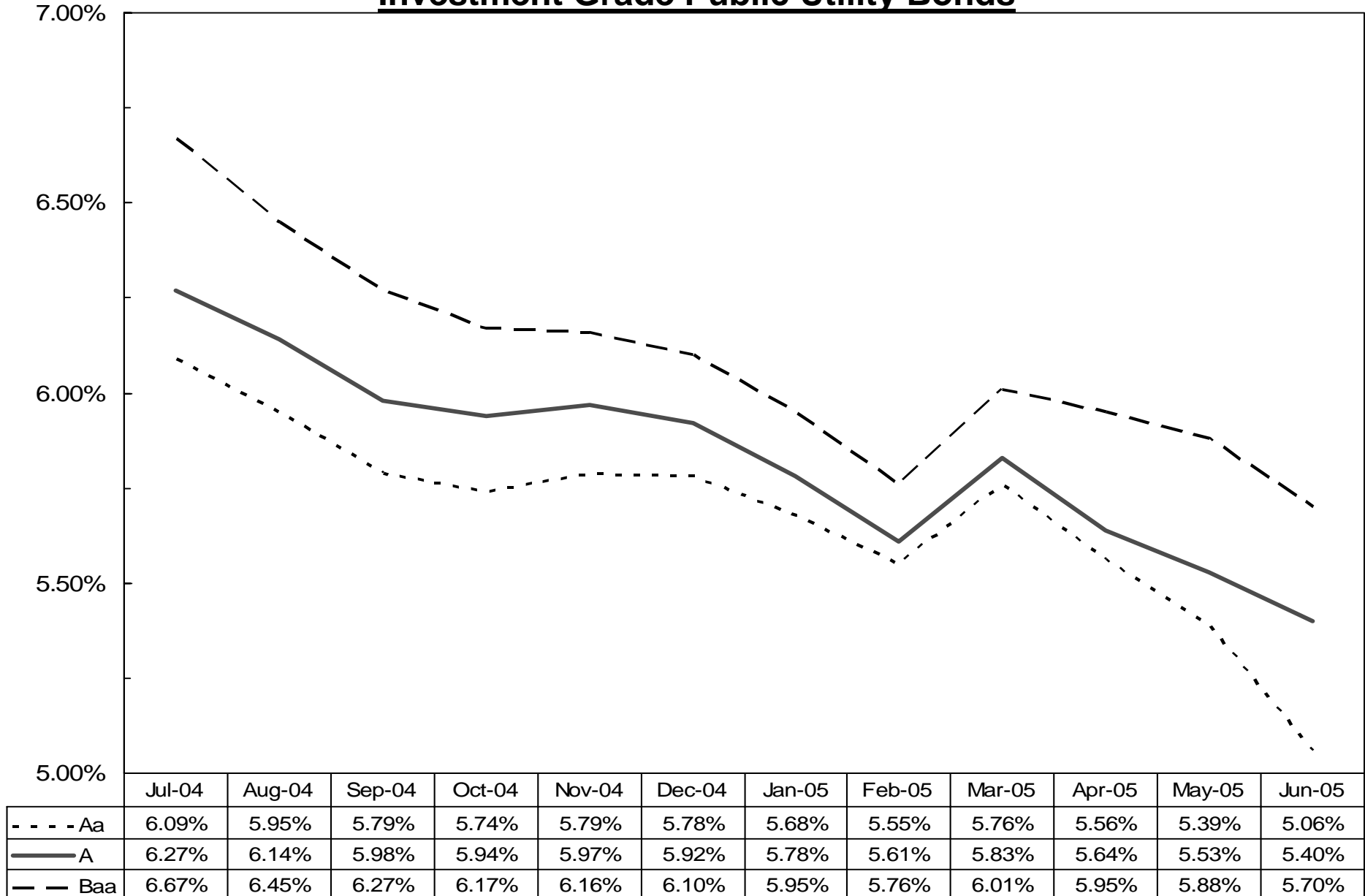
Electric Group

Five-Year Projected Growth Rates



Earnings per Share=EPS Book Values per Share=BVPS
 Dividends per Share=DPS Cash Flow per Share=CFPS
 Percent Retained to Common Equity=BxR

Interest Rates for Investment Grade Public Utility Bonds

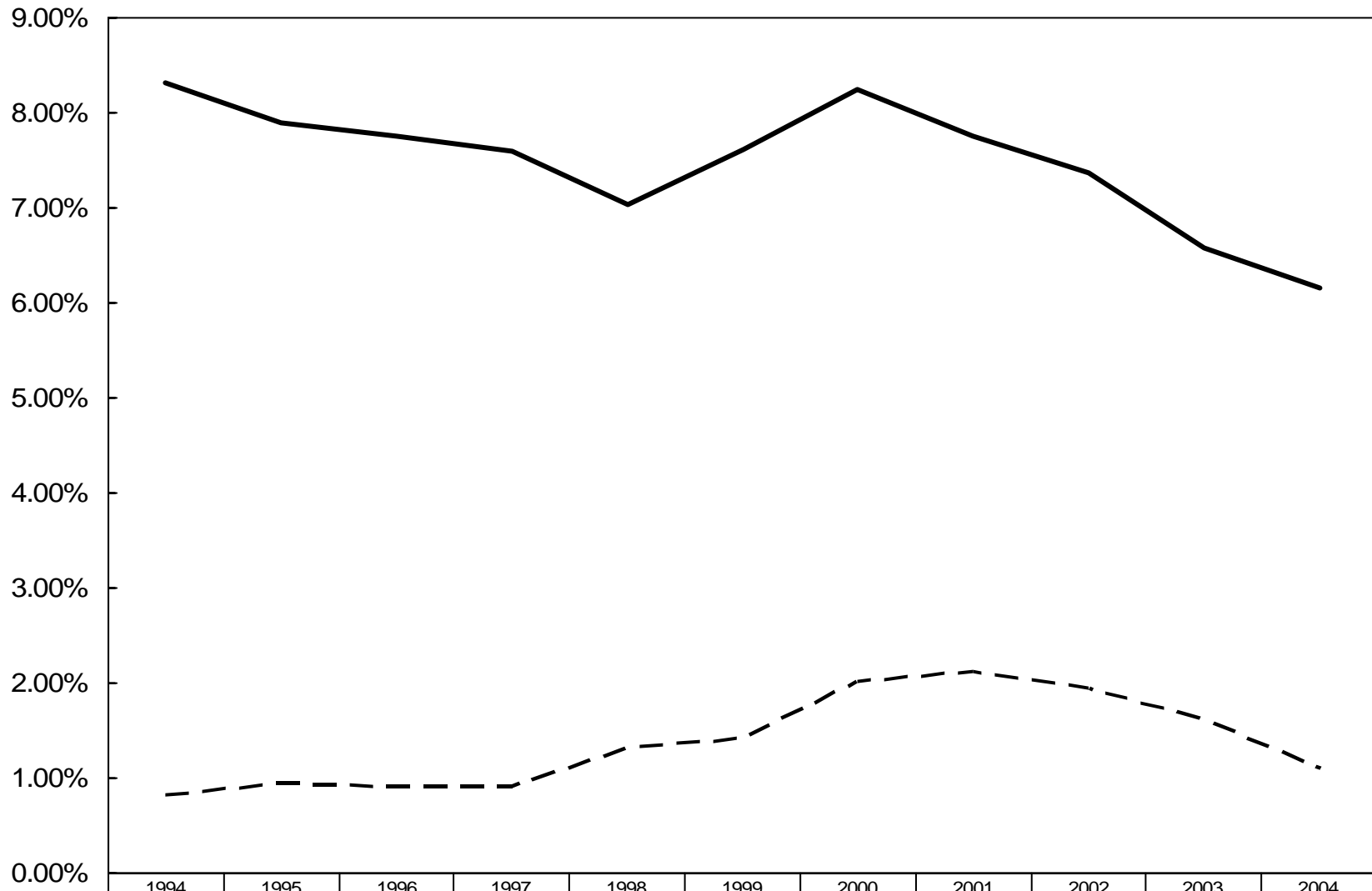


**Interest Rates for Investment Grade Public Utility Bonds
Yearly for 2000-2004
and the Twelve Months Ended June 2005**

<u>Years</u>	<u>Aa Rated</u>	<u>A Rated</u>	<u>Baa Rated</u>	<u>Average</u>
2000	8.06%	8.24%	8.36%	8.14%
2001	7.58%	7.76%	8.03%	7.72%
2002	7.19%	7.37%	8.02%	7.53%
2003	6.40%	6.58%	6.84%	6.61%
2004	6.04%	6.16%	6.40%	6.20%
Five-Year Average	<u>7.05%</u>	<u>7.22%</u>	<u>7.53%</u>	<u>7.24%</u>
<u>Months</u>				
Jul-04	6.09%	6.27%	6.67%	6.34%
Aug-04	5.95%	6.14%	6.45%	6.18%
Sep-04	5.79%	5.98%	6.27%	6.01%
Oct-04	5.74%	5.94%	6.17%	5.95%
Nov-04	5.79%	5.97%	6.16%	5.97%
Dec-04	5.78%	5.92%	6.10%	5.93%
Jan-05	5.68%	5.78%	5.95%	5.80%
Feb-05	5.55%	5.61%	5.76%	5.64%
Mar-05	5.76%	5.83%	6.01%	5.86%
Apr-05	5.56%	5.64%	5.95%	5.72%
May-05	5.39%	5.53%	5.88%	5.60%
Jun-05	5.06%	5.40%	5.70%	5.39%
Twelve-Month Average	<u>5.68%</u>	<u>5.83%</u>	<u>6.09%</u>	<u>5.87%</u>
Six-Month Average	<u>5.50%</u>	<u>5.63%</u>	<u>5.88%</u>	<u>5.67%</u>
Three-Month Average	<u>5.34%</u>	<u>5.52%</u>	<u>5.84%</u>	<u>5.57%</u>

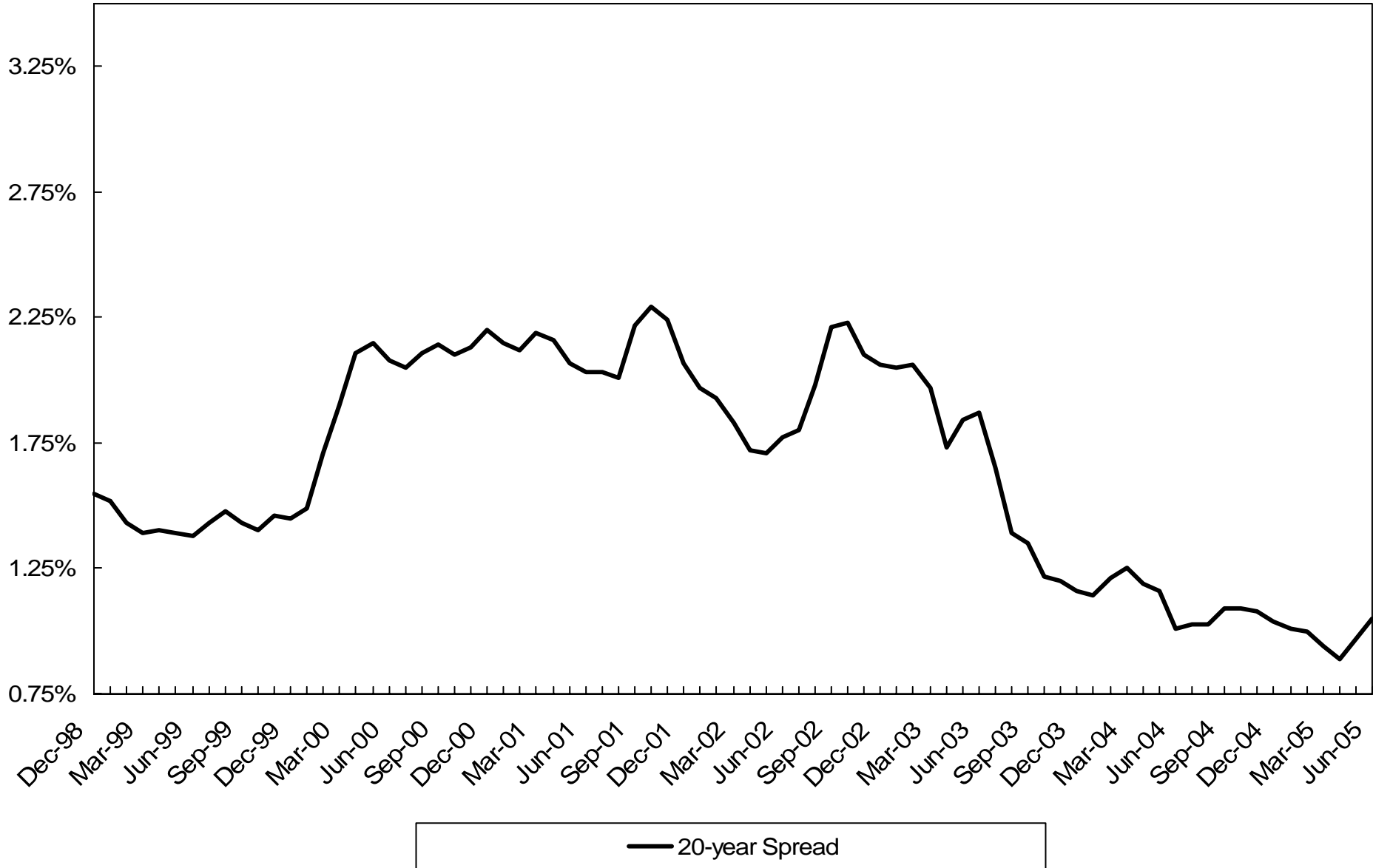
Source: Mergent Bond Record

Yields on A-rated Public Utility Bonds and Spreads over 20-Year Treasuries



 A-rated Public Utility	8.31%	7.89%	7.75%	7.60%	7.04%	7.62%	8.24%	7.76%	7.37%	6.58%	6.16%
 Spread vs. 20-year	0.82%	0.94%	0.92%	0.91%	1.32%	1.42%	2.01%	2.13%	1.94%	1.62%	1.11%

Interest Rate Spreads A-rated Public Utility Bonds over 20-Year Treasuries



A rated Public Utility Bonds
over 20-Year Treasuries

Year	A-rated Public Utility	20-Year Treasuries	
		Yield	Spread
Dec-98	6.91%	5.36%	1.55%
Jan-99	6.97%	5.45%	1.52%
Feb-99	7.09%	5.66%	1.43%
Mar-99	7.26%	5.87%	1.39%
Apr-99	7.22%	5.82%	1.40%
May-99	7.47%	6.08%	1.39%
Jun-99	7.74%	6.36%	1.38%
Jul-99	7.71%	6.28%	1.43%
Aug-99	7.91%	6.43%	1.48%
Sep-99	7.93%	6.50%	1.43%
Oct-99	8.06%	6.66%	1.40%
Nov-99	7.94%	6.48%	1.46%
Dec-99	8.14%	6.69%	1.45%
Jan-00	8.35%	6.86%	1.49%
Feb-00	8.25%	6.54%	1.71%
Mar-00	8.28%	6.38%	1.90%
Apr-00	8.29%	6.18%	2.11%
May-00	8.70%	6.55%	2.15%
Jun-00	8.36%	6.28%	2.08%
Jul-00	8.25%	6.20%	2.05%
Aug-00	8.13%	6.02%	2.11%
Sep-00	8.23%	6.09%	2.14%
Oct-00	8.14%	6.04%	2.10%
Nov-00	8.11%	5.98%	2.13%
Dec-00	7.84%	5.64%	2.20%
Jan-01	7.80%	5.65%	2.15%
Feb-01	7.74%	5.62%	2.12%
Mar-01	7.68%	5.49%	2.19%
Apr-01	7.94%	5.78%	2.16%
May-01	7.99%	5.92%	2.07%
Jun-01	7.85%	5.82%	2.03%
Jul-01	7.78%	5.75%	2.03%
Aug-01	7.59%	5.58%	2.01%
Sep-01	7.75%	5.53%	2.22%
Oct-01	7.63%	5.34%	2.29%
Nov-01	7.57%	5.33%	2.24%
Dec-01	7.83%	5.76%	2.07%
Jan-02	7.66%	5.69%	1.97%
Feb-02	7.54%	5.61%	1.93%
Mar-02	7.76%	5.93%	1.83%
Apr-02	7.57%	5.85%	1.72%
May-02	7.52%	5.81%	1.71%
Jun-02	7.42%	5.65%	1.77%
Jul-02	7.31%	5.51%	1.80%
Aug-02	7.17%	5.19%	1.98%
Sep-02	7.08%	4.87%	2.21%
Oct-02	7.23%	5.00%	2.23%
Nov-02	7.14%	5.04%	2.10%
Dec-02	7.07%	5.01%	2.06%
Jan-03	7.07%	5.02%	2.05%
Feb-03	6.93%	4.87%	2.06%
Mar-03	6.79%	4.82%	1.97%
Apr-03	6.64%	4.91%	1.73%
May-03	6.36%	4.52%	1.84%
Jun-03	6.21%	4.34%	1.87%
Jul-03	6.57%	4.92%	1.65%
Aug-03	6.78%	5.39%	1.39%
Sep-03	6.56%	5.21%	1.35%
Oct-03	6.43%	5.21%	1.22%
Nov-03	6.37%	5.17%	1.20%
Dec-03	6.27%	5.11%	1.16%
Jan-04	6.15%	5.01%	1.14%
Feb-04	6.15%	4.94%	1.21%
Mar-04	5.97%	4.72%	1.25%
Apr-04	6.35%	5.16%	1.19%
May-04	6.62%	5.46%	1.16%
Jun-04	6.46%	5.45%	1.01%
Jul-04	6.27%	5.24%	1.03%
Aug-04	6.14%	5.07%	1.07%
Sep-04	5.98%	4.89%	1.09%
Oct-04	5.94%	4.85%	1.09%
Nov-04	5.97%	4.89%	1.08%
Dec-04	5.92%	4.88%	1.04%
Jan-05	5.78%	4.77%	1.01%
Feb-05	5.61%	4.61%	1.00%
Mar-05	5.83%	4.89%	0.94%
Apr-05	5.64%	4.75%	0.89%
May-05	5.53%	4.56%	0.97%
Jun-05	5.40%	4.35%	1.05%

S&P Composite Index and S&P Public Utility Index
Long-Term Corporate and Public Utility Bonds
Yearly Total Returns
1928-2004

Year	S & P Composite Index	S & P Public Utility Index	Long Term Corporate Bonds	Public Utility Bonds
1928	43.61%	57.47%	2.84%	3.08%
1929	-8.42%	11.02%	3.27%	2.34%
1930	-24.90%	-21.96%	7.98%	4.74%
1931	-43.34%	-35.90%	-1.85%	-11.11%
1932	-8.19%	-0.54%	10.82%	7.25%
1933	53.99%	-21.87%	10.38%	-3.82%
1934	-1.44%	-20.41%	13.84%	22.61%
1935	47.67%	76.63%	9.61%	16.03%
1936	33.92%	20.69%	6.74%	8.30%
1937	-35.03%	-37.04%	2.75%	-4.05%
1938	31.12%	22.45%	6.13%	8.11%
1939	-0.41%	11.26%	3.97%	6.76%
1940	-9.78%	-17.15%	3.39%	4.45%
1941	-11.59%	-31.57%	2.73%	2.15%
1942	20.34%	15.39%	2.60%	3.81%
1943	25.90%	46.07%	2.83%	7.04%
1944	19.75%	18.03%	4.73%	3.29%
1945	36.44%	53.33%	4.08%	5.92%
1946	-8.07%	1.26%	1.72%	2.98%
1947	5.71%	-13.16%	-2.34%	-2.19%
1948	5.50%	4.01%	4.14%	2.65%
1949	18.79%	31.39%	3.31%	7.16%
1950	31.71%	3.25%	2.12%	2.01%
1951	24.02%	18.63%	-2.69%	-2.77%
1952	18.37%	19.25%	3.52%	2.99%
1953	-0.99%	7.85%	3.41%	2.08%
1954	52.62%	24.72%	5.39%	7.57%
1955	31.56%	11.26%	0.48%	0.12%
1956	6.56%	5.06%	-6.81%	-6.25%
1957	-10.78%	6.36%	8.71%	3.58%
1958	43.36%	40.70%	-2.22%	0.18%
1959	11.96%	7.49%	-0.97%	-2.29%
1960	0.47%	20.26%	9.07%	9.01%
1961	26.89%	29.33%	4.82%	4.65%
1962	-8.73%	-2.44%	7.95%	6.55%
1963	22.80%	12.36%	2.19%	3.44%
1964	16.48%	15.91%	4.77%	4.94%
1965	12.45%	4.67%	-0.46%	0.50%
1966	-10.06%	-4.48%	0.20%	-3.45%
1967	23.98%	-0.63%	-4.95%	-3.63%
1968	11.06%	10.32%	2.57%	1.87%
1969	-8.50%	-15.42%	-8.09%	-6.66%
1970	4.01%	16.56%	18.37%	15.90%
1971	14.31%	2.41%	11.01%	11.59%
1972	18.98%	8.15%	7.26%	7.19%
1973	-14.66%	-18.07%	1.14%	2.42%
1974	-26.47%	-21.55%	-3.06%	-5.28%
1975	37.20%	44.49%	14.64%	15.50%
1976	23.84%	31.81%	18.65%	19.04%
1977	-7.18%	8.64%	1.71%	5.22%
1978	6.56%	-3.71%	-0.07%	-0.98%
1979	18.44%	13.58%	-4.18%	-2.75%
1980	32.42%	15.08%	-2.76%	-0.23%
1981	-4.91%	11.74%	-1.24%	4.27%
1982	21.41%	26.52%	42.56%	33.52%
1983	22.51%	20.01%	6.26%	10.33%
1984	6.27%	26.04%	16.86%	14.82%
1985	32.16%	33.05%	30.09%	26.48%
1986	18.47%	28.53%	19.85%	18.16%
1987	5.23%	-2.92%	-0.27%	3.02%
1988	16.81%	18.27%	10.70%	10.19%
1989	31.49%	47.80%	16.23%	15.61%
1990	-3.17%	-2.57%	6.78%	8.13%
1991	30.55%	14.61%	19.89%	19.25%
1992	7.67%	8.10%	9.39%	8.65%
1993	9.99%	14.41%	13.19%	10.59%
1994	1.31%	-7.94%	-5.76%	-4.72%
1995	37.43%	42.15%	27.20%	22.81%
1996	23.07%	3.14%	1.40%	3.04%
1997	33.36%	24.69%	12.95%	11.39%
1998	28.58%	14.82%	10.76%	9.44%
1999	21.04%	-8.85%	-7.45%	-1.69%
2000	-9.11%	59.70%	12.87%	9.45%
2001	-11.88%	-30.41%	10.65%	5.85%
2002	-22.10%	-30.04%	16.33%	1.63%
2003	28.70%	26.11%	5.27%	10.01%
2004	10.87%	24.22%	8.72%	6.03%
Geometric Mean	10.10%	8.55%	5.89%	5.50%
Arithmetic Mean	12.08%	10.94%	6.22%	5.79%
Standard Deviation	20.37%	22.81%	8.67%	7.98%
Median	14.31%	11.26%	4.14%	4.65%

**Tabulation of Risk Rate Differentials for
S&P Public Utility Index and Public Utility Bonds
For the Years 1928-2004, 1952-2004, 1974-2004, and 1979-2004**

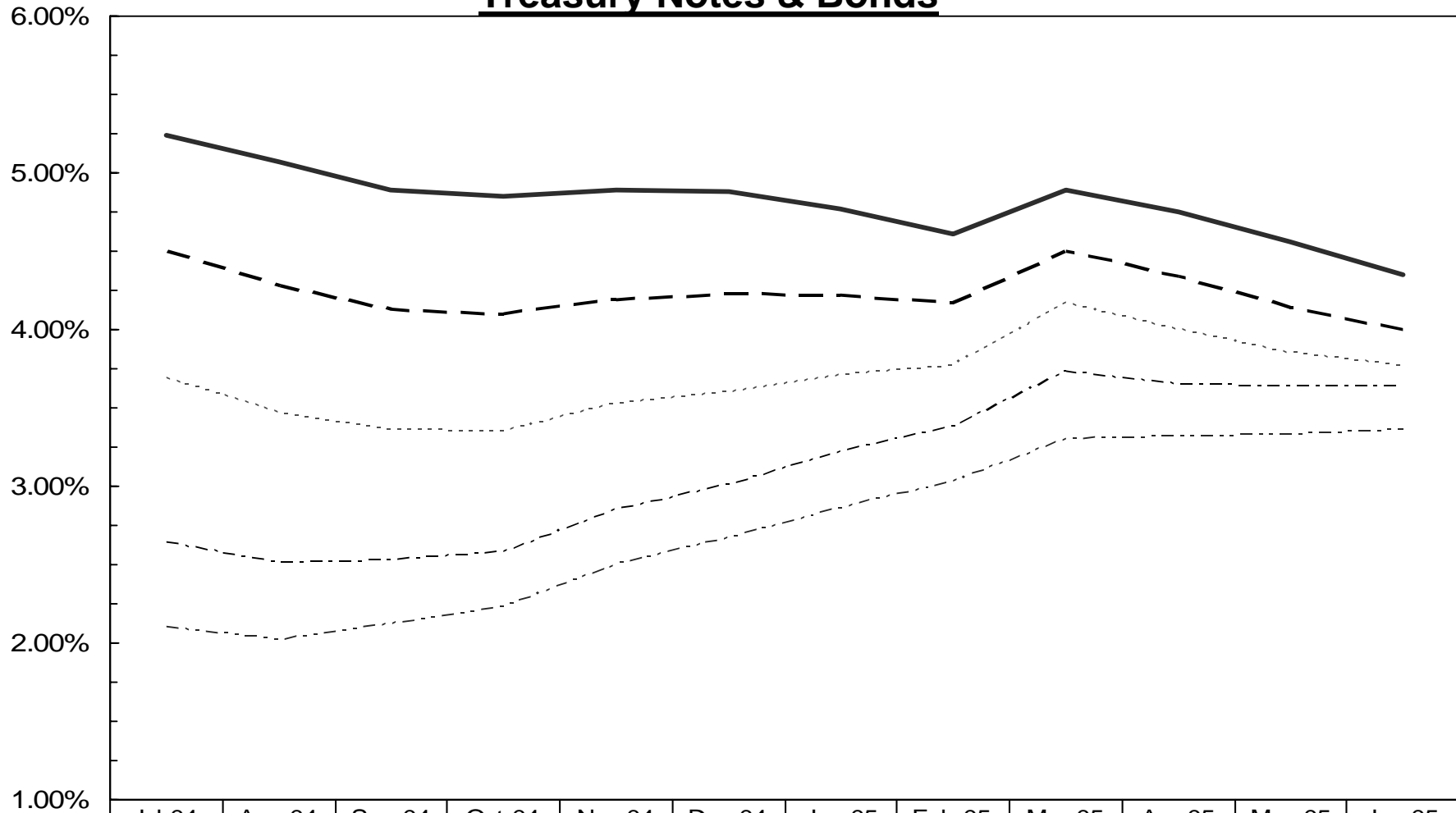
<u>Total Returns</u>	<u>Range</u>		<u>Midpoint</u>	<u>Point</u>	<u>Average</u>
	<u>Geometric</u>	<u>Median</u>		<u>Estimate</u>	
	<u>Mean</u>			<u>Arithmetic</u>	<u>of the</u>
				<u>Mean</u>	<u>Midpoint</u>
					<u>of Range</u>
					<u>and Point</u>
					<u>Estimate</u>
<u>1928-2004</u>					
S&P Public Utility Index	8.55%	11.26%		10.94%	
Public Utility Bonds	<u>5.50%</u>	<u>4.65%</u>		<u>5.79%</u>	
Risk Differential	<u>3.05%</u>	<u>6.61%</u>	<u>4.83%</u>	<u>5.15%</u>	<u>4.99%</u>
<u>1952-2004</u>					
S&P Public Utility Index	10.71%	12.36%		12.29%	
Public Utility Bonds	<u>6.27%</u>	<u>5.22%</u>		<u>6.59%</u>	
Risk Differential	<u>4.44%</u>	<u>7.14%</u>	<u>5.79%</u>	<u>5.70%</u>	<u>5.75%</u>
<u>1974-2004</u>					
S&P Public Utility Index	12.41%	14.82%		14.50%	
Public Utility Bonds	<u>8.89%</u>	<u>9.44%</u>		<u>9.25%</u>	
Risk Differential	<u>3.52%</u>	<u>5.38%</u>	<u>4.45%</u>	<u>5.25%</u>	<u>4.85%</u>
<u>1979-2004</u>					
S&P Public Utility Index	13.01%	14.95%		14.99%	
Public Utility Bonds	<u>9.39%</u>	<u>9.45%</u>		<u>9.74%</u>	
Risk Differential	<u>3.62%</u>	<u>5.50%</u>	<u>4.56%</u>	<u>5.25%</u>	<u>4.91%</u>

**Value Line Betas for
Electric Group**

Company	Beta
CH Energy Group	0.80
Central Vermont P.S.	0.50
Consolidated Edison	0.60
Duquesne Light Holdings	0.80
Energy East Corp.	0.85
Green Mountain Power	0.60
Northeast Utilities	0.80
NSTAR	0.70
UIL Holdings	0.80
Average	<u>0.72</u>

Source of Information:
Value Line Investment Survey
issue dated June 3, 2005

Yields on Treasury Notes & Bonds



	Jul-04	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04	Jan-05	Feb-05	Mar-05	Apr-05	May-05	Jun-05
1-Year	2.10%	2.02%	2.12%	2.23%	2.50%	2.67%	2.86%	3.03%	3.30%	3.32%	3.33%	3.36%
2-Year	2.64%	2.51%	2.53%	2.58%	2.85%	3.01%	3.22%	3.38%	3.73%	3.65%	3.64%	3.64%
5-Year	3.69%	3.47%	3.36%	3.35%	3.53%	3.60%	3.71%	3.77%	4.17%	4.00%	3.85%	3.77%
10-Year	4.50%	4.28%	4.13%	4.10%	4.19%	4.23%	4.22%	4.17%	4.50%	4.34%	4.14%	4.00%
20-Year	5.24%	5.07%	4.89%	4.85%	4.89%	4.88%	4.77%	4.61%	4.89%	4.75%	4.56%	4.35%

**Yields for Treasury Constant Maturities
Yearly for 2000-2004
and the Twelve Months Ended June 2005**

<u>Years</u>	<u>1-Year</u>	<u>2-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>7-Year</u>	<u>10-Year</u>	<u>20-Year</u>
2000	6.11%	6.26%	6.22%	6.16%	6.20%	6.03%	6.23%
2001	3.49%	3.83%	4.09%	4.56%	4.88%	5.02%	5.63%
2002	2.00%	2.64%	3.10%	3.82%	4.30%	4.61%	5.43%
2003	1.24%	1.65%	2.11%	2.97%	3.52%	4.02%	4.96%
2004	1.89%	2.38%	2.78%	3.43%	3.87%	4.27%	5.05%
Five-Year Average	<u>2.95%</u>	<u>3.35%</u>	<u>3.66%</u>	<u>4.19%</u>	<u>4.55%</u>	<u>4.79%</u>	<u>5.46%</u>
<u>Months</u>							
Jul-04	2.10%	2.64%	3.05%	3.69%	4.11%	4.50%	5.24%
Aug-04	2.02%	2.51%	2.88%	3.47%	3.90%	4.28%	5.07%
Sep-04	2.12%	2.53%	2.83%	3.36%	3.75%	4.13%	4.89%
Oct-04	2.23%	2.58%	2.85%	3.35%	3.75%	4.10%	4.85%
Nov-04	2.50%	2.85%	3.09%	3.53%	3.88%	4.19%	4.89%
Dec-04	2.67%	3.01%	3.21%	3.60%	3.93%	4.23%	4.88%
Jan-05	2.86%	3.22%	3.39%	3.71%	3.97%	4.22%	4.77%
Feb-05	3.03%	3.38%	3.54%	3.77%	3.97%	4.17%	4.61%
Mar-05	3.30%	3.73%	3.91%	4.17%	4.33%	4.50%	4.89%
Apr-05	3.32%	3.65%	3.79%	4.00%	4.16%	4.34%	4.75%
May-05	3.33%	3.64%	3.72%	3.85%	3.94%	4.14%	4.56%
Jun-05	3.36%	3.64%	3.69%	3.77%	3.86%	4.00%	4.35%
Twelve-Month Average	<u>2.74%</u>	<u>3.12%</u>	<u>3.33%</u>	<u>3.69%</u>	<u>3.96%</u>	<u>4.23%</u>	<u>4.81%</u>
Six-Month Average	<u>3.20%</u>	<u>3.54%</u>	<u>3.67%</u>	<u>3.88%</u>	<u>4.04%</u>	<u>4.23%</u>	<u>4.66%</u>
Three-Month Average	<u>3.34%</u>	<u>3.64%</u>	<u>3.73%</u>	<u>3.87%</u>	<u>3.99%</u>	<u>4.16%</u>	<u>4.55%</u>

Source: Federal Reserve statistical release H.15

Measures of the Risk-Free Rate

The forecast of Treasury yields
per the consensus of nearly 50 economists
reported in the Blue Chip Financial Forecasts dated July 1, 2005

<u>Year</u>	<u>Quarter</u>	<u>1-Year Treasury Bill</u>	<u>2-Year Treasury Note</u>	<u>5-Year Treasury Note</u>	<u>10-Year Treasury Note</u>	<u>20-Year Treasury Bond</u>
2005	Third	3.8%	4.0%	4.1%	4.3%	4.7%
2005	Fourth	4.0%	4.2%	4.4%	4.6%	4.9%
2006	First	4.2%	4.4%	4.5%	4.7%	5.1%
2006	Second	4.3%	4.5%	4.7%	4.8%	5.2%
2006	Third	4.4%	4.6%	4.7%	4.9%	5.3%
2006	Fourth	4.5%	4.6%	4.8%	4.9%	5.3%

July 1, 2005

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SCREENS

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The Median of Estimated
PRICE-EARNINGS RATIOS
of all stocks with earnings

18.6

26 Weeks	Market Low	Market High
Ago	10-9-02	3-7-05
19.3	14.1	18.9

The Median of Estimated
DIVIDEND YIELDS
(next 12 months) of all dividend
paying stocks under review

1.6%

26 Weeks	Market Low	Market High
Ago	10-9-02	3-7-05
1.6%	2.4%	1.6%

The Estimated Median Price
APPRECIATION POTENTIAL
of all 1700 stocks in the hypothesized
economic environment 3 to 5 years hence

50%

26 Weeks	Market Low	Market High
Ago	10-9-02	3-7-05
35%	115%	40%

ANALYSES OF INDUSTRIES IN ALPHABETICAL ORDER WITH PAGE NUMBER

Numeral in parenthesis after the industry is rank for probable performance (next 12 months).

PAGE		PAGE		PAGE		PAGE	
Advertising (41)	1920	Educational Services (29)	1578	Insurance (Prop/Cas.) (38)	585	Railroad (9)	284
Aerospace/Defense (30)	543	Electrical Equipment (42)	1001	Internet (13)	2224	R.E.I.T. (98)	1173
Air Transport (67)	253	*Electric Util. (Central) (76)	695	Investment Co. (35)	959	Recreation (82)	1841
Apparel (72)	1651	Electric Utility (East) (85)	156	Investment Co. (Foreign) (21)	362	Restaurant (54)	292
Auto & Truck (28)	101	Electric Utility (West) (86)	1777	Machinery (53)	1331	Retail Automotive (15)	1666
*Auto Parts (96)	789	Electronics (87)	1023	Manuf. Housing/RV (95)	1548	Retail Building Supply (12)	880
Bank (78)	2101	Entertainment (26)	1860	Maritime (33)	275	Retail (Special Lines) (55)	1709
Bank (Canadian) (80)	1564	Entertainment Tech (83)	1591	Medical Services (5)	630	Retail Store (61)	1675
Bank (Midwest) (94)	613	Environmental (74)	352	Medical Supplies (22)	180	Securities Brokerage (34)	1424
Beverage (Alcoholic) (31)	1533	Financial Svcs. (Div.) (45)	2130	Metal Fabricating (50)	564	Semiconductor (40)	1051
Beverage (Soft Drink) (75)	1539	Food Processing (77)	1481	Metals & Mining (Div.) (20)	1223	Semiconductor Equip (39)	1092
Biotechnology (64)	668	Food Wholesalers (73)	1528	Natural Gas (Distrib.) (97)	460	Shoe (43)	1697
Building Materials (92)	851	Foreign Electronics (32)	1555	Natural Gas (Div.) (17)	439	Steel (General) (51)	574
*Cable TV (4)	821	*Foreign Telecom. (25)	764	Newspaper (88)	1906	Steel (Integrated) (69)	1414
Canadian Energy (27)	428	Furn/Home Furnishings (84)	894	Office Equip/Supplies (56)	1137	*Telecom. Equipment (36)	741
Cement & Aggregates (37)	887	Grocery (46)	1514	Oilfield Svcs/Equip. (16)	1939	*Telecom. Services (70)	719
Chemical (Basic) (8)	1235	Healthcare Information (19)	656	Packaging & Container (81)	925	Thrift (57)	1161
Chemical (Diversified) (44)	1961	Home Appliance (47)	119	Paper/Forest Products (63)	908	Tire & Rubber (52)	113
Chemical (Specialty) (66)	477	Homebuilding (2)	866	Petroleum (Integrated) (10)	405	Tobacco (93)	1571
Coal (1)	523	Hotel/Gaming (48)	1876	Petroleum (Producing) (6)	1929	*Toiletries/Cosmetics (58)	809
Computers/Peripherals (24)	1107	Household Products (79)	942	*Pharmacy Services (3)	779	Trucking (23)	265
Computer Software/Svcs (18)	2166	Human Resources (59)	1286	Power (90)	974	Water Utility (89)	1420
Diversified Co. (60)	1376	Industrial Services (68)	323	Precious Metals (91)	1215	Wireless Networking (14)	511
Drug (62)	1243	Information Services (7)	377	Precision Instrument (71)	126		
E-Commerce (11)	1440	Insurance (Life) (49)	1200	Publishing (65)	1892		

*Reviewed in this week's issue.

In three parts: This is Part 1, the Summary & Index. Part 2 is Selection & Opinion. Part 3 is Ratings & Reports. Volume LX, No. 44.

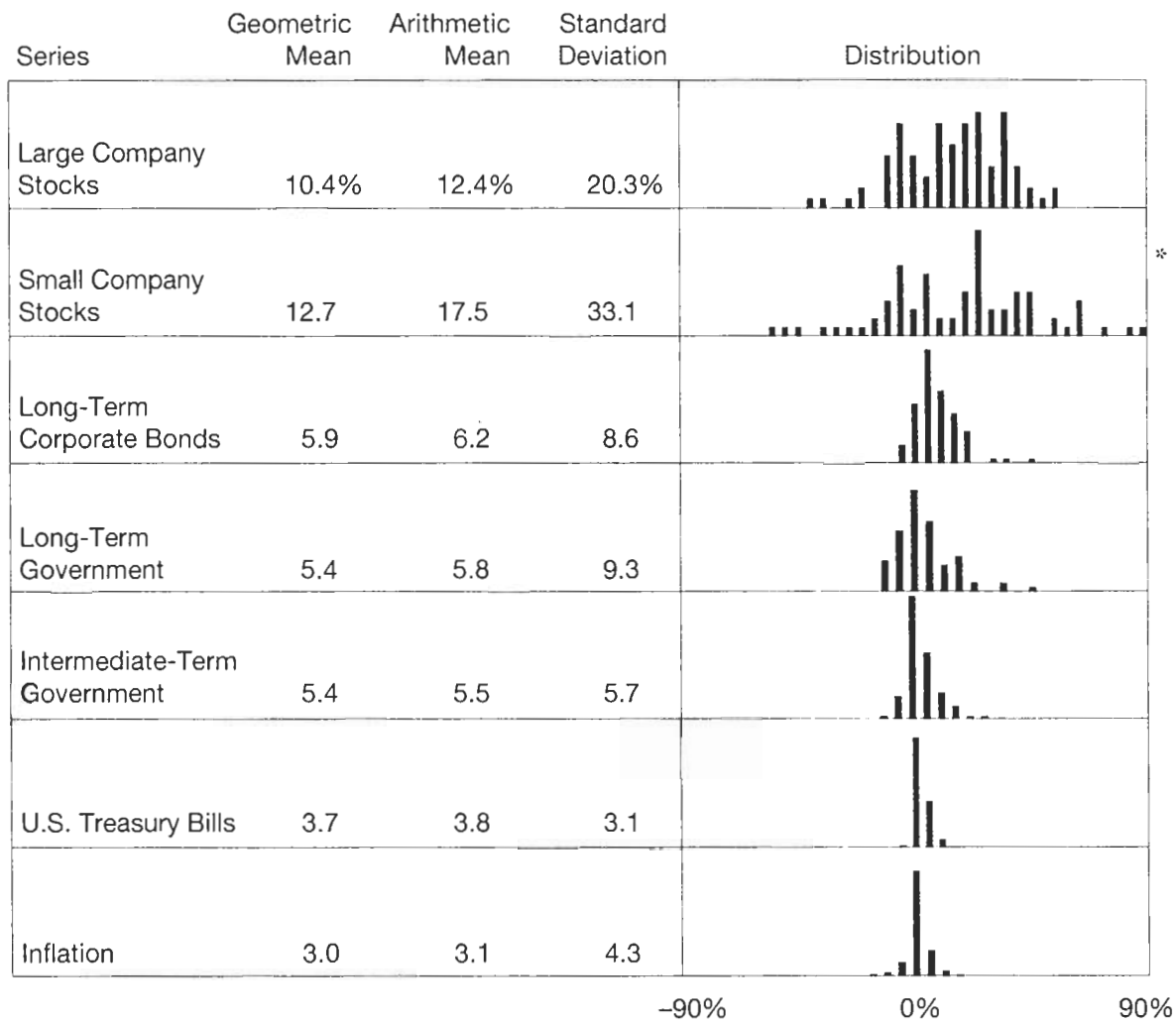
Published weekly by VALUE LINE PUBLISHING, INC. 220 East 42nd Street, New York, N.Y. 10017-5891

Table 2-1

Basic Series: Summary Statistics of Annual Total Returns

D.T.E. 05-85
 Exhibit NSTAR Electric-PRM-2
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from 1926 to 2004



*The 1933 Small Company Stocks Total Return was 142.9 percent.

Comparable Earnings Approach

Using All Value Line Non-Utility Companies with
Timeliness of 3, 4 & 5; Safety Rank of 1, 2, 3 & 4; Financial Strength of B, B+, B++, A, A+ & A++;
Price Stability of 75 to 100; Betas of .50 to .85; and Technical Rank of 3 & 4

Company	Industry	Timeliness Rank	Safety Rank	Financial Strength	Price Stability	Beta	Technical Rank
Abbott Labs.	MEDSUPPL	3	1	A++	80	0.80	3
ABM Industries Inc.	INDUSRV	4	2	B++	85	0.80	4
Alleghany Corp.	INSPRPTY	4	1	A	100	0.55	3
Ampco-Pittsburgh	STEEL	3	3	B+	90	0.60	3
Anheuser-Busch	ALCO-BEV	3	1	A++	100	0.55	3
Archer Daniels Midl'd	FOODPROC	4	3	B+	85	0.70	3
Arrow Int'l	MEDSUPPL	4	2	A	90	0.65	3
Ball Corp.	PACKAGE	3	3	B++	80	0.85	3
Banta Corp.	PUBLISH	4	2	B++	95	0.75	3
Barnes Group	DIVERSIF	3	3	B+	80	0.80	3
Beckman Coulter	MEDSUPPL	5	3	B+	80	0.55	3
Becton Dickinson	MEDSUPPL	3	1	A+	85	0.80	3
Biomet	MEDSUPPL	3	2	A	75	0.80	3
Bob Evans Farms	RESTRNT	5	2	B++	80	0.85	4
BOK Financial	BANKMID	3	2	B++	95	0.80	4
Capitol Fed. Fin'l	THRIFT	3	2	B++	95	0.75	3
Casey's Gen'l Stores	GROCERY	4	3	B	75	0.85	3
Chevron Corp.	OILINTEG	3	1	A++	100	0.85	3
Cincinnati Financial	INSPRPTY	3	2	B++	95	0.85	3
City National Corp.	BANK	3	2	B++	95	0.85	3
CLARCOR Inc.	PACKAGE	3	2	B++	85	0.85	3
Clorox Co.	HOUSEPRD	3	2	B++	85	0.65	3
Coca-Cola Bottling	BEVERAGE	4	3	B	80	0.55	3
Commerce Bancshs.	BANKMID	4	1	A	100	0.80	3
ConAgra Foods	FOODPROC	5	1	B++	95	0.70	3
Cooper Cos.	MEDSUPPL	3	3	B++	75	0.75	3
Corn Products Int'l	FOODPROC	5	2	B++	80	0.80	3
Curtiss-Wright	MACHINE	3	2	B++	85	0.70	3
Dentsply Int'l	MEDSUPPL	3	2	B++	90	0.70	3
Dionex Corp.	INSTRMNT	4	3	B+	80	0.85	4
Dofasco	STEELINT	3	3	B+	90	0.80	4
Dun & Bradstreet	INFOSER	3	3	B	90	0.80	3
Enterprise Products	GASDIVRS	3	3	B	85	0.65	3
ESCO Technologies	DIVERSIF	3	3	B++	80	0.80	3
First Midwest Bancorp	BANKMID	4	2	B++	95	0.85	3
Franklin Electric	ELECEQ	3	2	B++	80	0.70	4
Freddie Mac	FINANCL	4	2	A	85	0.85	4
Gannett Co.	NWSPAPER	4	1	A++	95	0.85	3
Gen'l Dynamics	DEFENSE	3	1	A++	85	0.80	3
Gen'l Mills	FOODPROC	4	1	A	100	0.55	3
Hancock Holding	BANKMID	3	2	B++	90	0.75	3
Harland (John H.)	PUBLISH	3	3	B++	75	0.75	3
Heinz (H.J.)	FOODPROC	3	1	A+	100	0.60	3
Hillenbrand Inds.	DIVERSIF	5	2	A	90	0.75	3
Int'l Flavors & Frag.	CHEMSPEC	4	2	B++	85	0.75	3
Invacare Corp.	MEDSUPPL	5	3	B+	80	0.85	3
Kellogg	FOODPROC	3	2	B++	95	0.60	3
Kimball Int'l 'B'	FURNITUR	3	3	B++	75	0.85	4
Kimberly-Clark	HOUSEPRD	4	1	A++	100	0.65	3
Knight Ridder	NWSPAPER	5	1	A+	100	0.85	3
Kraft Foods	FOODPROC	3	1	A+	95	0.65	3
Lancaster Colony	HOUSEPRD	4	1	A+	90	0.75	3
Lance Inc.	FOODPROC	3	3	B+	80	0.75	4
Lauder (Estee)	COSMETIC	3	2	A	80	0.85	3
Lawson Products	METALFAB	5	2	A	80	0.70	4
Lee Enterprises	NWSPAPER	4	1	A	100	0.85	3
Liberty Corp.	ENTRTAIN	4	2	B+	95	0.75	3
Lincoln Elec Hldgs.	MACHINE	3	2	A	75	0.85	3
Markel Corp.	INSPRPTY	3	2	B++	95	0.80	4
Mattel Inc.	RECREATE	3	3	B++	80	0.75	3
Matthews Int'l	DIVERSIF	3	3	B+	85	0.70	3
McClatchy Co.	NWSPAPER	3	1	A	95	0.75	3
McGraw-Hill	PUBLISH	3	1	A+	95	0.80	3
Mercury General	INSPRPTY	3	2	B++	90	0.85	4
Meredith Corp.	PUBLISH	3	1	A	95	0.85	4
National Presto Ind.	APPLIANC	3	2	B+	100	0.65	3
Newell Rubbermaid	HOUSEPRD	3	3	B+	75	0.85	3
Northrop Grumman	DEFENSE	3	3	B+	85	0.65	3
Old Nat'l Bancorp	BANKMID	4	2	B++	100	0.70	4
Packaging Corp.	PACKAGE	3	3	B+	85	0.85	3
Pactiv Corp.	PACKAGE	4	3	B+	80	0.85	3
People's Bank	THRIFT	3	3	B+	90	0.85	3
Plum Creek Timber	PAPER	4	2	B+	95	0.80	3
Popular Inc.	BANK	3	3	B+	100	0.75	4
Procter & Gamble	HOUSEPRD	3	1	A++	100	0.55	3
Quaker Chemical	CHEMSPEC	5	3	B+	75	0.85	4
Regis Corp.	COSMETIC	4	3	B+	75	0.85	3
Republic Services	ENVIRONM	3	3	B+	80	0.70	3
Ryan's Restaurant	RESTRNT	5	3	B+	75	0.80	3
SAFECO Corp.	INSPRPTY	3	3	B+	75	0.85	3
Scripps (E.W.) 'A'	NWSPAPER	3	2	B+	100	0.85	3
Selective Ins. Group	INSPRPTY	3	3	B+	80	0.85	3
Sensient Techn.	FOODPROC	5	2	B++	85	0.80	4
ServiceMaster Co.	INDUSRV	3	3	B+	80	0.80	3
Sigma-Aldrich	CHEMSPEC	3	2	A	90	0.80	3
Tennant Co.	MACHINE	4	2	B++	85	0.85	3
Tootsie Roll Ind.	FOODPROC	3	1	A+	95	0.65	3
Topps Co.	RECREATE	4	3	B+	75	0.75	3
Transatlantic Hldgs.	INSPRPTY	3	2	B++	100	0.80	3
Unilever NV (NY Shs)	FOODPROC	3	1	A++	95	0.80	3
Union Pacific	RAILROAD	3	3	B+	90	0.85	3
United Parcel Serv.	AIRTRANS	3	1	A+	100	0.80	4
Universal Corp.	TOBACCO	4	2	B++	95	0.70	3
Varian Medical Sys.	MEDSUPPL	3	2	A	75	0.80	4
Wal-Mart Stores	RETAIL	3	1	A++	90	0.85	3
Washington Federal	THRIFT	4	1	A+	95	0.85	3
Washington Post	NWSPAPER	4	1	A+	100	0.70	3
Weis Markets	GROCERY	4	1	A	95	0.75	3
Wendy's Int'l	RESTRNT	3	2	A	80	0.70	3
Wiley (John) & Sons	PUBLISH	3	3	B+	85	0.80	3
Wrigley (Wm.) Jr.	FOODPROC	4	1	A++	100	0.55	3
Zimmer Holdings	MEDSUPPL	3	2	A	80	0.75	3
Average		4	2	B++	88	0.76	3
Electric Group	Range	3 to 5	1 to 4	B to A+++	75 to 100	.50 to .85	3 to 4
	Average	4	2	B++	92	0.72	3

Comparable Earnings Approach
Five -Year Average Historical Earned Returns
for Years 2000-2004 and
Projected 3-5 Year Returns

Company	2000	2001	2002	2003	2004	Average	Projected 2008-10
Abbott Labs.	32.5%	32.5%	30.4%	26.6%	24.6%	29.3%	27.5%
ABM Industries Inc.	13.7%	12.5%	12.1%	8.2%	9.5%	11.2%	14.0%
Alleghany Corp.	2.9%	15.8%	4.0%	10.4%	3.5%	7.3%	7.0%
Ampco-Pittsburgh	10.0%	NMF	3.4%	1.8%	NMF	5.1%	11.0%
Anheuser-Busch	37.6%	42.0%	63.4%	76.6%	84.0%	60.7%	85.0%
Archer Daniels Midl'd	4.9%	6.1%	6.8%	6.2%	9.7%	6.7%	9.5%
Arrow Int'l	17.0%	14.3%	13.1%	13.3%	12.5%	14.0%	15.0%
Ball Corp.	16.6%	21.0%	32.3%	29.4%	27.7%	25.4%	18.0%
Banta Corp.	15.8%	14.2%	13.3%	11.7%	12.6%	13.5%	13.0%
Barnes Group	17.7%	9.6%	13.0%	10.3%	10.8%	12.3%	13.5%
Beckman Coulter	36.5%	27.3%	26.9%	20.3%	19.3%	26.1%	13.5%
Becton Dickinson	20.1%	18.8%	19.3%	19.6%	22.0%	20.0%	20.0%
Biomet	18.4%	17.2%	20.4%	22.3%	22.5%	20.2%	24.0%
Bob Evans Farms	11.1%	12.5%	13.4%	11.4%	6.0%	10.9%	11.0%
BOK Financial	14.2%	15.2%	13.8%	12.9%	12.8%	13.8%	11.0%
Capitol Fed. Fin'l	7.7%	7.4%	9.1%	5.3%	4.6%	8.5%	9.5%
Casey's Gen'l Stores	10.3%	8.6%	9.8%	8.3%	9.5%	9.3%	11.5%
Chevron Corp.	26.0%	9.7%	3.6%	19.9%	29.5%	17.7%	15.0%
Cincinnati Financial	2.0%	3.2%	5.4%	6.2%	8.4%	5.0%	7.5%
City National Corp.	17.7%	16.4%	16.3%	15.3%	15.3%	16.2%	14.0%
CLARCOR Inc.	16.6%	15.3%	14.8%	14.7%	14.9%	15.3%	13.0%
Clorox Co.	23.4%	20.2%	23.8%	42.3%	35.5%	29.0%	61.0%
Coca-Cola Bottling	9.5%	38.5%	69.0%	58.5%	33.9%	41.9%	33.5%
Commerce Bancshs.	15.6%	14.3%	14.1%	14.2%	15.4%	14.7%	16.5%
ConAgra Foods	27.0%	17.1%	18.2%	18.2%	16.4%	19.4%	17.5%
Cooper Cos.	14.6%	14.5%	15.7%	16.3%	17.1%	15.6%	18.5%
Corn Products Int'l	6.4%	6.7%	7.6%	8.3%	8.7%	7.5%	10.0%
Curtiss-Wright	13.1%	11.6%	10.1%	10.9%	11.3%	11.4%	11.0%
Dentsply Int'l	19.4%	18.0%	17.5%	15.4%	13.6%	16.8%	12.5%
Dionex Corp.	28.7%	24.5%	21.0%	19.7%	22.6%	23.3%	23.0%
Dofasco	10.2%	1.5%	12.4%	7.6%	17.4%	9.8%	12.0%
Dun & Bradstreet	-	-	-	NMF	NMF	-	34.5%
Enterprise Products	-	-	-	-	-	-	-
ESCO Technologies	5.4%	6.1%	7.1%	12.0%	12.6%	8.6%	14.0%
First Midwest Bancorp	16.9%	18.4%	18.3%	17.8%	18.6%	18.0%	19.5%
Franklin Electric	20.9%	22.0%	21.0%	17.9%	16.3%	19.6%	16.0%
Freddie Mac	24.7%	15.0%	32.2%	15.3%	9.0%	19.2%	17.5%
Gannett Co.	19.0%	14.5%	16.8%	14.4%	16.1%	16.2%	15.0%
Gen'l Dynamics	23.6%	20.8%	20.2%	16.8%	16.8%	19.6%	14.5%
Gen'l Mills	NMF	NMF	16.2%	24.0%	20.8%	20.3%	21.0%
Hancock Holding	10.1%	9.7%	12.0%	12.6%	12.5%	11.4%	13.5%
Harland (John H.)	16.7%	19.3%	22.4%	22.0%	20.1%	20.1%	21.5%
Heinz (H.J.)	65.8%	49.3%	59.5%	41.1%	31.8%	49.5%	21.5%
Hillenbrand Inds.	18.7%	17.7%	19.8%	21.1%	17.5%	19.0%	17.0%
Int'l Flavors & Frag.	23.7%	25.8%	32.0%	26.9%	21.5%	26.0%	17.0%
Invacare Corp.	15.1%	15.8%	13.5%	11.6%	10.0%	13.2%	12.0%
Kellogg	72.6%	61.1%	79.4%	54.5%	39.5%	61.4%	30.0%
Kimball Int'l B'	10.3%	8.2%	5.8%	1.3%	5.0%	6.1%	9.5%
Kimberly-Clark	31.2%	30.9%	30.9%	25.4%	27.2%	29.1%	30.0%
Knight Ridder	20.4%	11.8%	19.3%	19.9%	22.5%	18.8%	18.0%
Kraft Foods	14.2%	8.0%	13.6%	12.1%	10.7%	11.7%	10.0%
Lancaster Colony	24.6%	19.6%	16.6%	16.1%	13.4%	18.1%	14.0%
Lance Inc.	12.6%	13.4%	11.0%	13.1%	12.5%	12.5%	15.0%
Lauder (Estee)	20.7%	20.3%	15.8%	18.7%	21.7%	19.4%	26.5%
Lawson Products	16.3%	8.7%	7.7%	9.7%	11.9%	10.9%	14.5%
Lee Enterprises	14.9%	9.7%	9.6%	9.7%	9.8%	10.7%	10.0%
Liberty Corp.	4.4%	2.8%	6.1%	4.6%	11.0%	5.8%	8.5%
Lincoln Elec Hldgs.	19.3%	16.8%	17.2%	11.7%	14.8%	16.0%	14.5%
Markel Corp.	NMF	NMF	3.2%	6.1%	9.8%	6.4%	12.0%
Mattel Inc.	20.9%	20.5%	24.6%	24.9%	22.0%	22.6%	18.5%
Matthews Int'l	22.0%	21.0%	21.1%	17.5%	18.0%	19.9%	15.0%
McClatchy Co.	9.3%	6.3%	12.5%	11.9%	11.1%	10.2%	9.5%
McGraw-Hill	26.2%	25.9%	26.6%	24.6%	24.7%	25.6%	21.5%
Mercury General	10.6%	9.8%	10.2%	14.1%	18.4%	12.6%	16.0%
Meredith Corp.	21.3%	17.8%	11.2%	18.4%	18.8%	17.5%	18.5%
National Presto Ind.	6.2%	2.7%	3.6%	6.3%	6.0%	5.0%	7.0%
Newell Rubbermaid	18.5%	13.1%	20.5%	20.2%	21.6%	18.8%	19.0%
Northrop Grumman	15.9%	5.5%	4.8%	4.8%	6.4%	7.5%	10.5%
Old Nat'l Bancorp	14.0%	15.5%	14.8%	9.8%	9.6%	12.7%	14.5%
Packaging Corp.	19.9%	14.0%	6.1%	5.3%	6.3%	10.3%	19.5%
Pactiv Corp.	9.3%	9.8%	24.5%	21.7%	20.4%	17.1%	15.0%
People's Bank	12.3%	2.6%	5.9%	6.4%	7.8%	7.0%	12.5%
Plum Creek Timber	16.8%	9.2%	10.5%	9.7%	12.2%	11.7%	16.0%
Popular Inc.	13.8%	13.4%	14.6%	17.1%	15.8%	14.9%	15.5%
Procter & Gamble	34.4%	36.6%	36.9%	35.4%	37.5%	36.2%	27.0%
Quaker Chemical	20.2%	16.8%	16.2%	13.2%	7.6%	14.8%	9.5%
Regis Corp.	18.8%	15.6%	15.8%	15.4%	15.3%	16.2%	15.0%
Republic Services	13.4%	12.1%	12.6%	11.3%	12.7%	12.4%	17.0%
Ryan's Restaurant	14.9%	14.2%	15.7%	14.0%	12.1%	14.2%	10.0%
SAFECO Corp.	2.1%	NMF	6.1%	8.1%	14.5%	7.7%	11.5%
Scripps (E.W.) 'A'	12.8%	10.6%	15.2%	13.6%	13.8%	13.2%	13.5%
Selective Ins. Group	4.6%	4.5%	6.1%	7.7%	12.8%	7.1%	12.5%
Sensient Techn.	16.7%	15.1%	16.2%	13.4%	11.5%	14.6%	11.0%
ServiceMaster Co.	15.9%	9.4%	14.0%	19.4%	17.4%	15.2%	19.0%
Sigma-Aldrich	16.2%	17.4%	14.8%	19.3%	19.2%	17.4%	14.5%
Tennant Co.	18.2%	3.1%	8.0%	8.5%	8.5%	9.3%	12.0%
Tootsie Roll Ind.	16.5%	12.9%	12.6%	12.1%	11.3%	13.1%	10.0%
Topps Co.	45.0%	14.7%	8.6%	6.0%	6.0%	16.1%	10.0%
Transatlantic Hldgs.	11.4%	1.0%	8.3%	12.8%	9.8%	8.7%	12.0%
Unilever NV (NY Shs)	37.3%	24.1%	42.4%	71.6%	65.0%	48.1%	29.5%
Union Pacific	9.0%	8.7%	9.3%	8.5%	6.0%	8.3%	9.0%
United Parcel Serv.	28.7%	23.7%	19.4%	18.9%	19.8%	22.1%	19.0%
Universal Corp.	23.7%	21.4%	18.1%	18.3%	13.5%	19.0%	12.0%
Varian Medical Sys.	19.6%	17.2%	19.8%	23.2%	27.3%	21.4%	34.0%
Wal-Mart Stores	20.1%	19.1%	20.4%	20.3%	20.8%	20.1%	21.5%
Washington Federal	13.9%	13.0%	15.0%	13.8%	11.8%	13.5%	15.0%
Washington Post	9.1%	4.3%	11.4%	8.7%	13.7%	9.4%	13.0%
Weis Markets	7.9%	10.1%	10.4%	9.5%	10.0%	9.6%	10.0%
Wendy's Int'l	16.1%	18.8%	15.1%	13.4%	14.2%	15.5%	15.0%
Wiley (John) & Sons	26.8%	23.5%	22.3%	20.7%	19.0%	22.5%	14.0%
Wrigley (Wm.) Jr.	29.0%	28.4%	26.4%	24.5%	22.6%	26.2%	22.0%
Zimmer Holdings	73.6%	242.4%	70.4%	9.3%	15.2%	82.2%	14.5%
Average						17.7%	16.9%
Median						15.2%	14.5%